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Supreme Court, U.S.  
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IN THE  
Supreme Court of the United States

MARK LEVY,  
*Petitioner,*

v.

STERLING HOLDING COMPANY, LLC;  
NATIONAL SEMICONDUCTOR CORPORATION; AND  
FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,  
*Respondents.*

On Petition for a Writ of Certiorari  
to the United States Court of Appeals  
for the Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

1. Whether the rule against retroactive agency rulemaking of *Bowen v. Georgetown University Hospital*, 488 U.S. 204 (1988), and the principles of retroactivity analysis of *Landgraf v. USI Film Products*, 511 U.S. 244 (1994), are categorically inapplicable to amended agency rules that purport to clarify agency rules but that conflict with courts of appeals' prior interpretations of those rules.

2. Whether the Securities and Exchange Commission's new Rule 16b-3, 17 C.F.R. § 240.16b-3 (2005) — which exempts from disgorgement those short-swing profits realized from an insider's acquisition of securities from the insider's own company — is a lawful interpretation of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), which provides for a broad, prophylactic right to recover profits acquired by an insider as a result of short-swing transactions in the insider's own company's securities.

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Mark Levy respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

## INTRODUCTION

This case presents an acknowledged conflict among the circuits regarding the proper application of this Court's decisions in *Bowen v. Georgetown University Hospital*, 488 U.S. 204 (1988), and *Landgraf v. USI Film Products*, 511 U.S. 244 (1994), with respect to agency rules. This Court held in *Bowen* that agencies, such as the Securities and Exchange Commission ("SEC"), presumptively lack the authority to adopt retroactive rules. In *Landgraf*, this Court explained how to identify those statutes and rules that have retroactive effect. Notwithstanding this Court's guidance, at least three pervasive and deep splits exist among the courts of appeals regarding the circumstances in which agency rules fit within the ambit of *Bowen* and *Landgraf*. This case implicates all three conflicts, each of which could be outcome-determinative in petitioner's favor.

First, the Third Circuit held that, in determining whether an agency's purported clarification of a rule has a retroactive effect, it is of no moment whether the amending rule is substantially inconsistent with a prior interpretation of the existing rule by a court of appeals. That decision creates an acknowledged conflict among the Fourth, Tenth, and D.C. Circuits on one side, and the Third and Seventh Circuits on the other. That difference in legal standard, moreover, is outcome-determinative because the SEC's "clarifying" rule conflicts with a prior Third Circuit decision. Second, the Third Circuit concluded that so-called clarifying agency rules are excluded auto-



matically and categorically from the prohibition of *Bowen* and the principles of *Landgraf*. That holding adds to a mature circuit split that now involves nine courts of appeals. Third, the Third Circuit held that a rule's status as legislative or interpretive has no bearing on retroactivity analysis. That squarely conflicts with decisions of the D.C. and Seventh Circuits; the conflict is likely outcome-determinative in this case because the SEC's new Rule 16b-3, 17 C.F.R. § 240.16b-3 (2005), is legislative in nature. This Court should grant the petition and resolve those conflicts.

Certiorari is also warranted on the second question presented. The Third Circuit below held that Congress has delegated to the SEC near plenary authority to create exemptions to Section 16(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78p(b). In fact, Congress provided the SEC with limited authority to create exemptions for transactions not contemplated by the "purpose" of Section 16(b), which implements the Exchange Act's objective of containing manipulation and unreasonable fluctuations in share prices that had contributed to the Great Depression. Traditional tools of statutory construction compel the conclusion that Section 16(b)'s "purpose" is broadly to prevent insiders from profiting from short-swing transactions regardless of whether those transactions were founded on insider information or informational asymmetries. The Third Circuit therefore erred in granting deference to the SEC's blinkered interpretation of Section 16(b)'s "purpose."

Because Section 16(b) is critical to fulfilling the Exchange Act's objectives, the petition should be granted.

## OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-31a) is reported at 544 F.3d 493. The opinion of the district court (Pet. App. 32a-62a) is reported at 475 F. Supp. 2d 463. A prior opinion of the court of appeals (Pet. App. 63a-99a) is reported at 314 F.3d 106.

## JURISDICTION

The court of appeals entered its judgment on October 1, 2008, and denied a petition for rehearing on November 18, 2008 (Pet. App. 100a). On February 10, 2009, Justice Souter extended the time within which to file a petition for a writ of certiorari to and including March 18, 2009. *Id.* at 114a. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

## STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), and the 1996 and 2005 versions of SEC Rules 16b-3 and 16b-7, 17 C.F.R. §§ 240.16b-3 and 240.16b-7, are reproduced at Pet. App. 102a-113a.

## STATEMENT

### A. Legal Background

This case involves the provision of the Securities Exchange Act of 1934 ("Exchange Act") that provides for disgorgement of profits when insiders engage in short-swing trading. See 15 U.S.C. § 78p(b). Disgorgement is designed to remove any incentive that insiders may have to engage in speculative abuse through such trades. Specifically, Section 16 allows corporations and their shareholders the right to recover any profits from officers, directors, and beneficial owners (that is, owners of more than 10% of



any given class of stock) who bought and sold (or sold and bought) a security within six months. *See id.* § 78p(a), (b).

At the heart of this litigation is an exchange of Fairchild Semiconductor International, Inc. ("Fairchild") preferred stock, owned by National Semiconductor Corporation ("National") and Sterling Holding Company, LLC ("Sterling"), for Fairchild Class A common stock. National and Sterling claim that SEC rules have exempted from recovery the profits realized from National's and Sterling's acquisition of Class A common stock through the exchange, and National's and Sterling's subsequent short-swing sales of Class A common stock.

Section 16(b) calls for the disgorgement of profits by insiders who have engaged in short-swing trading. Liability under the section has four elements: (1) the purchase (or sale) of a security; (2) the sale (or purchase) of a security; (3) within a period of six months; (4) by an officer, director, or beneficial owner of more than 10% of any class of the issuer's securities. *See id.* § 78p(b).

At issue here is whether National's and Sterling's exchange of Fairchild preferred stock for Class A common stock in August 1999 qualifies as a purchase under Section 16(b). If it does, National and Sterling are subject to disgorgement pursuant to Section 16(b) because the other three elements are indisputably satisfied here: National and Sterling sold the securities in January 2000; the sale was within six months of the exchange; and National and Sterling were statutory insiders, as they both appointed senior executive officers to Fairchild's board of directors and were also beneficial owners of more than 10% of both classes of common stock. *See Pet. App. 4a.*

Section 16(b) exempts those short-swing transactions that “the [SEC] by rules and regulations may exempt as not comprehended within the purpose of this subsection.” 15 U.S.C. § 78p(b). The statute itself partially elucidates the purpose, which the SEC is tasked with implementing: “preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.” *Id.* Although the statute makes reference to insider trading, scholars have noted that other statutes also address insider trading, often more directly and concretely than does Section 16(b). See Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L.J. 391, 394-95 (1991). Thus, beyond a general concern with insider trading, Section 16(b)’s purpose is a concern with short-swing trading as an evil in itself, regardless of whether such trading is the product of insider information. The statute’s drafters sought to prevent *speculation*, not just trading on inside information, by officers, directors, and substantial beneficial owners of company stock. See S. Rep. No. 73-1455, at 186-87 (1934).

The SEC has promulgated exemptive rules to Section 16(b), one of which is relevant here. Rule 16b-3(d) exempts certain grants and awards from Section 16(b)’s ambit. The version of Rule 16b-3(d) in effect from 1996 to 2005 — the time period pertinent to this case — provided, in relevant part:

Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the

board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated . . . ; or

(3) The issuer of equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

17 C.F.R. § 240.16b-3(d) (1996).

When it promulgated Rule 16b-3, the SEC stated the rule's purpose as exempting transactions associated with employee benefit plans from Section 16(b). *See Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release Nos. 34-37260, 35-26524, 61 Fed. Reg. 30,376, 30,378-79 (June 14, 1996). In *Levy v. Sterling Holding Co.*, 314 F.3d 106 (3d Cir. 2002) ("*Levy I*"), the precursor appeal in this case, the Third Circuit held that transactions must have a "compensatory nexus" to qualify for the exemption embodied in Rule 16b-3. Pet. App. 97a-98a.

Responding to *Levy I*, the SEC in 2005 promulgated a new rule expanding the scope of the exemption. New Rule 16b-3 provides:

Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (*including without limitation a grant or award*), whether or not intended for a compensatory or other particular purpose, shall be exempt if [one of the same three conditions is met].

17 C.F.R. § 240.16b-3(d) (2005) (relevant changes italicized).<sup>1</sup>

## **B. Facts and Proceedings Below**

1. In 1997, Fairchild was created as a spinoff of National, a Delaware corporation, pursuant to an Agreement and Plan of Recapitalization. Under the agreement, National and Sterling were permitted to appoint three of the seven members of Fairchild's board of directors. The agreement also provided that National and Sterling would receive a mix of the three classes of Fairchild stock that were created: (1) Class A common stock, which included voting rights; (2) Class B common stock, which did not include voting rights; and (3) preferred stock, which provided for a cumulative dividend. Both National and Sterling are undisputedly insiders covered by Section 16(b): National owned 14.8% of the Class A common stock, Sterling held 48% of the Class A common stock, and they each appointed their senior executive officers as members of Fairchild's board of directors (National appointed its CEO; Sterling appointed two of its senior executive officers). By virtue of that insider status, National and Sterling were at all relevant times subject to Section 16(b).

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<sup>1</sup> Although National and Sterling argued that both new Rules 16b-3 and 16b-7 exempted their exchange of preferred stock for Class A common stock from the ambit of Section 16(b), the Third Circuit in *Levy II* resolved the case based on the application of new Rule 16b-3 alone.

In 1999, upon the unanimous consent of its board of directors, Fairchild prepared to undertake an initial public offering ("IPO"). As part of a recapitalization effort that preceded the IPO, Fairchild's board of directors, on the advice of the underwriter, an affiliate of Sterling, voted unanimously to recommend that all preferred stock be converted into Class A common stock. On July 1, 1999, with National and Sterling together controlling 62.8% of the Class A common stock, a majority of the Class A common stockholders voted to approve the exchange of Fairchild preferred stock for Fairchild Class A common stock. The exchange required an amendment of Fairchild's Certificate of Incorporation, which in turn required Sterling's consent. Both National and Sterling consented to the amendment. The IPO was completed on August 9, 1999. In accordance with the proposed conversion formula, National's preferred stock was converted into 888,362 shares of Class A common stock and Sterling's preferred stock was converted into 4,021,428 shares of Class A common stock.

On January 19, 2000, barely five months after the IPO and the exchange of the preferred stock for Class A common stock had taken place, National sold 7,234,360 shares of its Class A common stock and Sterling sold 11,115,000 shares of its Class A common stock in Fairchild's secondary offering. As a consequence of these transactions, National and Sterling realized short-swing profits of \$12,850,679.60 and \$58,501,592.90, respectively.

In November 2000, petitioner, a shareholder in Fairchild, brought a suit on behalf of Fairchild against National and Sterling for the disgorgement of National's and Sterling's short-swing profits. In



the district court, National and Sterling argued that the then-applicable exemptions embodied in Rules 16b-3 and 16b-7 precluded liability and that the action should be dismissed. Based upon those exemptions, the court dismissed the action.

2. In *Levy I*, the Third Circuit reversed. The Third Circuit reviewed the release that accompanied the 1996 version of the rule and concluded that "Rule 16b-3 primarily is concerned with employee benefit plans." Pet. App. 94a. The court interpreted the "other acquisition" prong of the exemption to apply only to plans that provided for "participant-directed transactions," such as deferrals of bonuses into phantom stock and other deferred compensation programs, and held that the weight of the SEC's pronouncements on Rule 16b-3(d) suggested that a transaction would qualify for the exemption only if it has "some connection to a compensation-related function." *Id.* at 96a-97a, 98a. Although the Third Circuit acknowledged language in the SEC's release indicating that the transaction need not have a compensatory element, the court found that that language did not undercut its ultimate conclusion. Instead, such language simply indicated that "the form of a transaction is not what matters." *Id.* at 98a.

The Third Circuit emphasized that its reading was the soundest interpretation of Section 16(b)'s language and the most logical in advancing its purposes:

The result we reach is sensible. We think that adopting National's and Sterling's view would result in any transaction between the issuer company and an officer or director that meets the remaining requirements of Rule 16b-3(d) — approval of the transaction by the board of directors or a majority of shareholders, or holding of the

securities by the officer or director for more than six months — being immunized from section 16(b) liability. The potential for self-dealing could be great: in a closely held corporation, directors or a majority of shareholders could arrange for the acquisition of stock in advance of an IPO, and turn around and sell shares shortly after the IPO. Because of their insider status, there would be a concern about speculative abuse injurious to other market participants.

*Id.* at 98a (footnote omitted).<sup>2</sup> *Levy I* thus remanded the case to the district court for further proceedings.

3. After *Levy I*, the SEC in 2005 initiated a rulemaking for the express purpose of reversing the Third Circuit's holdings in this case with respect to the scope of Rules 16b-3 and 16b-7. The SEC indicated that, in expressing its disagreement with the Third Circuit, it was merely "clarifying" the scope of the exemptions. Pet. App. 12a (internal quotation marks omitted).

Following promulgation of the new exemptive rules, the district court ruled on the prior-filed cross-motions for summary judgment. The district court determined that the new rules promulgated in 2005 should apply to the conduct at issue — from 1999 and 2000 — and granted summary judgment to National and Sterling. *See id.* at 14a-15a.

4. This time on appeal, the Third Circuit affirmed the district court. In so doing, it rejected *Levy's* arguments that new Rule 16b-3 should not apply to

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<sup>2</sup> *Levy I* also rejected claims that Rule 16b-7 exempted the exchange of preferred stock for Class A common stock from Section 16(b). *See* Pet. App. 77a-84a. As noted above, though, the court in *Levy II* did not reach the issue of the applicability of new Rule 16b-7 to the present case.

conduct that predated the rule's promulgation. The court also disagreed with Levy's submission that the new rules exceed the scope of the SEC's rulemaking authority under Section 16(b).

The court below held that applying new Rule 16b-3 to conduct that predated its adoption did not present a retroactivity problem. The court reasoned that a rule that merely clarifies an earlier regulation may apply to prior conduct without being impermissibly retroactive. The Third Circuit articulated four factors that determine whether a rule is simply a clarification that can apply to earlier conduct: "(1) whether the text of the old regulation was ambiguous; (2) whether the new regulation resolved, or at least attempted to resolve, that ambiguity; (3) whether the new regulation's resolution of the ambiguity is consistent with the text of the old regulation; and (4) whether the new regulation's resolution of the ambiguity is consistent with the agency's prior treatment of the issue." Pet. App. 27a (citations omitted). In crafting that test, the court acknowledged the omission of one element that other circuits have found dispositive as to retroactivity analysis: whether the new rule conflicts with a judicial interpretation of the old rule. Thus, the Third Circuit expressly parted ways with the Fourth and D.C. Circuits on this issue. *See id.* at 28a.

The Third Circuit also rejected Levy's claim that the SEC's new rules are improper exercises of its authority under Section 16(b). The court held that the new rules pass muster under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). In effect, the court held that Congress had given the SEC virtually plenary power to decide



which transactions should be exempt from the ambit of Section 16(b) liability. *See* Pet. App. 20a-21a.

## REASONS FOR GRANTING THE PETITION

### I. THE THIRD CIRCUIT'S TEST FOR DETERMINING WHEN AGENCY CLARIFYING RULES HAVE RETROACTIVE EFFECT DEEPENS ACKNOWLEDGED CONFLICTS AMONG THE CIRCUITS AND DEPARTS FROM THIS COURT'S DECISIONS

This Court's precedents establish two concordant principles relating to retroactive agency decision-making. First, "[r]etroactivity is generally disfavored in the law in accordance with fundamental notions of justice that have been recognized throughout history." *Eastern Enters. v. Apfel*, 524 U.S. 498, 532 (1998) (plurality) (citation omitted; internal quotation marks omitted). A strong presumption against "retroactiv[ity]" exists that "is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic." *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265 (1994). Given the disfavored nature of retroactivity, federal courts are obligated to analyze carefully whether application of a law or regulation would have a retroactive effect. *See id.* at 269-70.

Second, because "retroactivity is not favored in the law," and because "an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress," agencies lack the authority to promulgate rules with retroactive effect unless their organic statute "requires this result." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988); *see also id.* at 223-24 (Scalia, J., concurring) ("[r]etroactive legislation has always been looked upon with disfavor," and it is therefore "unsurprising"

that Congress “has been unwilling to confer” retroactive rulemaking authority on agencies). The SEC has no such authority.

This case presents several acknowledged conflicts regarding application of these retroactivity principles. In determining whether the SEC’s new Rule 16b-3 could be applied to pending claims and, in fact, to conduct predating promulgation of the rule, the Third Circuit created a sharp split with other courts of appeals’ decisions on multiple issues concerning agency retroactivity. This Court’s review is needed to resolve these conflicts and to secure uniformity on the proper standards for assessing the retroactivity of agency rules. Certiorari is independently warranted because the decision below conflicts with the force of *Bowen* and *Landgraf* by allowing agencies to engage in retroactive rulemaking and to insinuate new rules into pending lawsuits.

**A. The Courts Of Appeals Are Divided With Respect To The Proper Legal Standard For Determining When Agency Rules Are Impermissibly Retroactive**

The Third Circuit’s test for identifying retroactive agency rules — which it applied in determining that the SEC’s new Rule 16b-3 does not implicate *Bowen* or *Landgraf* — conflicts with other courts of appeals’ judgments in three important respects.

1. *The Third Circuit’s decision deepens a sharp split among courts of appeals on whether agency rules inconsistent with previous courts of appeals’ decisions are necessarily retroactive as applied to pending claims*

The Third Circuit held that it is irrelevant whether “Congress has delegated retroactive rulemaking power to [an] agency” where a new rule that is applied to

conduct predating its promulgation “constitutes a clarification . . . of the law as it existed beforehand.” Pet. App. 26a. In applying that standard, the Third Circuit deemed it immaterial whether an agency amendment “conflicts with a judicial interpretation of the pre-amendment law.” *Id.* at 28a.

The Seventh Circuit follows a legal approach substantially similar to the Third Circuit’s. In *United States v. Fones*, 51 F.3d 663 (7th Cir. 1995), the Seventh Circuit held that, although a new comment to the Sentencing Guidelines “effectively nullifie[d] the law of the Seventh Circuit,” the comment must be treated “as a clarifying rather than substantive change.” *Id.* at 669. The court of appeals thus held that the new interpretation could be applied to prior conduct. *See id.*

The Third and Seventh Circuits’ approach conflicts with other courts of appeals’ decisions, as the court below acknowledged. *See* Pet. App. 28a-29a (citing Fourth and D.C. Circuit precedent as contrary authority). The D.C. Circuit, for example, has held that, if an agency rule conflicts with an earlier court of appeals’ decision, applying that rule to prior conduct would have a retroactive effect. In *National Mining Association v. Department of Labor*, 292 F.3d 849 (D.C. Cir. 2002), the D.C. Circuit applied *Bowen* and *Landgraf* to rules promulgated under the Black Lung Benefits Act. The government had posited that all of the rules were procedural and thus could be applied to prior conduct. The D.C. Circuit noted that an agency rule that “changes the legal landscape” of norms affecting primary conduct, if applied to prior conduct, would be impermissibly retroactive. *Id.* at 859 (internal quotation marks omitted). In determin-

ing whether a rule would change the legal landscape, the court applied the following legal standard:

If a new regulation is substantively inconsistent with a prior regulation, prior agency practice, or *any Court of Appeals decision rejecting a prior regulation or agency practice*, it is retroactive as applied to pending claims.

*Id.* at 860 (emphasis added); *accord Marrie v. SEC*, 374 F.3d 1196, 1208 (D.C. Cir. 2004).

The Fourth and Tenth Circuits' approach accords with the D.C. Circuit's. In *United States v. Capers*, 61 F.3d 1100 (4th Cir. 1995), the Fourth Circuit held that "an amendment should be classified as substantive, not clarifying, when it cannot be reconciled with circuit precedent." *Id.* at 1110. Similarly, the Tenth Circuit, in *United States v. Saucedo*, 950 F.2d 1508 (10th Cir. 1991), held that, when an amendment requires a court to overrule precedent, such an amendment cannot be a mere clarification; rather, the change is a substantive one. *See id.* at 1514-15. In each case, the Fourth and Tenth Circuits aligned themselves with the *National Mining Association* principle that a rule contradicting a prior court of appeals' decision is impermissibly retroactive if applied to prior conduct.

This conflict among the courts of appeals is both acknowledged, *see* Pet. App. 28a-29a, and outcome-determinative. New Rule 16b-3 unquestionably is substantively inconsistent with the Third Circuit's decision in *Levy I* — it was promulgated for that purpose. If this case had been brought in the D.C., Fourth, or Tenth Circuit, that fact alone would have compelled the conclusion that new Rule 16b-3 is substantive and may not be applied to pending claims or to conduct predating the rule's promulgation. In

those three circuits, the SEC could not have dictated the outcome of pending litigation involving underlying conduct predating the rule by several years, as it attempts to do here.

2. *The Third Circuit's conclusion that "clarifying" rules are not subject to analysis under Landgraf deepens confusion in and adds to disagreement among the circuits*

The Third Circuit's holding that an agency rule that "constitutes a clarification . . . of the law as it existed beforehand" (Pet. App. 26a) is not retroactive was unqualified: the court stated that, "where a new rule constitutes a clarification . . . , the application of that new rule to pre-promulgation conduct *necessarily* does *not* have an impermissible retroactive effect." *Id.* (first emphasis added). The court's conclusion that clarifying rules are categorically exempt from the *Landgraf* retroactivity analysis conflicts with the decisions of two circuits.

First, the decision below acknowledged that the standard it applied conflicts with the Federal Circuit's decision in *Princess Cruises, Inc. v. United States*, 397 F.3d 1358 (Fed. Cir. 2005). See Pet. App. 26a-27a (citing *Princess Cruises* as contrary authority). In that case, the Federal Circuit firmly rejected the principle applied by the Third Circuit here that clarifications can necessarily be given retroactive effect, explaining that "the binary analysis — change or clarification — [is] largely unhelpful." 397 F.3d at 1363. The Federal Circuit held that such analysis did not absolve courts of their "obligation to weigh the various factors described in *Landgraf*." *Id.*

Second, in *National Mining Association*, the D.C. Circuit held that labeling a rule as "procedural" or "substantive" is not dispositive of the retroactivity



question. Relying on *Landgraf*, the D.C. Circuit held that a retroactivity analysis requires “commonsense, functional judgment.” 292 F.3d at 859-60 (internal quotation marks omitted). The D.C. Circuit also made clear that, regardless of the label that attaches to a rule, courts must undertake the *Landgraf* analysis and assess whether the rule, in actuality, substantively changes the legal landscape and thus has retroactive effect. See *id.* at 859.

The D.C. and Federal Circuits’ approach conflicts with that of at least six circuits, which hold that there is an automatic and categorical exemption of clarifying laws from the *Landgraf* retroactivity analysis. The Fifth Circuit has held that, upon a determination that a new rule is a mere clarification, it “need not determine whether, under the rule set forth in *Landgraf* . . . , the [agency] intended the rule to have retroactive effect.” *Vo v. Gonzales*, 482 F.3d 363, 370 (5th Cir. 2007). The Fourth Circuit similarly holds that a statutory amendment that “merely clarified the meaning” of a statute did not constitute a “retroactive[.]” application and therefore is not subject to analysis under *Landgraf*. *Brown v. Thompson*, 374 F.3d 253, 258-61 & n.6 (4th Cir. 2004). The First Circuit has concluded that an “amendment” that “was not a change at all, but a clarification that did not alter the law,” is not subject to retroactivity analysis. *Liquilux Gas Corp. v. Martin Gas Sales*, 979 F.2d 887, 890 (1st Cir. 1992).

The Eleventh Circuit likewise has held that, once a court determines a rule is a clarification — even when that determination rests on little more than an agency’s assurance that the rule is such — no retroactivity concerns are implicated. See *Heimmermann v. First Union Mortgage Corp.*, 305 F.3d 1257, 1260

(11th Cir. 2002); *Piamba Cortes v. American Airlines, Inc.*, 177 F.3d 1272, 1283 (11th Cir. 1999). The Ninth Circuit had adopted a similar categorical rule with respect to legislation, see *ABKCO Music, Inc. v. La-Vere*, 217 F.3d 684, 689 (9th Cir. 2000) (“clarifying legislation is not subject to any presumption against retroactivity and is applied to all cases pending as of the date of its enactment”), and the Sixth Circuit has suggested it would do the same, see *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998) (“So long as a change in a regulation does not announce a new rule, but rather merely clarifies or codifies an existing policy, that regulation can apply retroactively.”).

In sum, disagreement over whether a clarifying law is categorically exempt from retroactivity analysis involves nine circuits and is longstanding. No purpose is served by greater percolation, and this case presents an ideal vehicle for this Court’s resolution.

3. *The Third Circuit’s holding that the status of the SEC’s rule as legislative is irrelevant to retroactivity analysis divides the circuits*

The Third Circuit below rejected petitioner’s argument that the SEC’s new Rule 16b-3 is a legislative rule and therefore that its retroactive application would impermissibly alter the substantive rights and liabilities of the parties. The court reasoned that the “legislative-interpretive dichotomy has *no bearing* on whether a rule has an impermissible retroactive effect.” Pet. App. 28a n.10 (emphasis added). The court explained that the only “significance” of a legislative classification of a rule is that an agency must promulgate it through “notice-and-comment rulemaking procedures.” *Id.*

The Third Circuit's unqualified holding that the difference between legislative and interpretive rules "has no bearing" on retroactivity analysis conflicts with decisions of the Seventh and D.C. Circuits. In *Health Insurance Association of America, Inc. v. Shalala*, 23 F.3d 412 (D.C. Cir. 1994), for example, the D.C. Circuit cited *Bowen* for the proposition that "agencies lack the power to promulgate retroactive legislative rules 'unless that power is conveyed by Congress in express terms.'" *Id.* at 422 (quoting *Bowen*, 488 U.S. at 208). Contrary to the Third Circuit's approach, the D.C. Circuit explicitly applied the rubric of *American Mining Congress v. Mine Safety & Health Administration*, 995 F.2d 1106, 1109-10 (D.C. Cir. 1993), to determine whether the underlying rule was in fact legislative or interpretive. See 23 F.3d at 422-23.

The Seventh Circuit has sided with the D.C. Circuit on this issue. In *First National Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472 (7th Cir. 1999), the Seventh Circuit reasoned that the framework for assessing whether a rule is legislative or interpretive is coterminous with the issue of whether an agency rule may apply to prior conduct. The Seventh Circuit thus has explained that, "[i]f the Clarifying Amendment is a legislative rule, [the appellant] wins. Under *Bowen*, an administrative rule only has retroactive effect if Congress expressly authorizes the agency to issue retroactive rules." *Id.* at 478 n.6.

This difference in legal standard, moreover, is not academic; it is likely outcome-determinative here. The test for determining the legislative or interpretive nature of a rule in *Health Insurance Association* and *American Mining Congress* compels the conclusion that new Rule 16b-3 is legislative. First, absent



the new rule, “the legislative basis” for application of the SEC’s exemptive rule “would be inadequate.” *American Mining Congress*, 995 F.2d at 1109. *Levy I* was a binding interpretation of Rule 16b-3; the SEC’s new rule is necessary to expand the scope of the exemption. Second, “an agency seems likely to have intended a rule to be legislative if it has the rule published in the Code of Federal Regulations,” *id.*, and here new Rule 16b-3 was so published, *see* 17 C.F.R. § 240.16b-3 (2005). Third, “the [SEC] has explicitly invoked” its rulemaking authority under Section 16(b), 995 F.2d at 1112, in promulgating new Rule 16b-3, *see* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 33-8600, 34-52202, 35-28013, 70 Fed. Reg. 46,080, 46,088 (Aug. 9, 2005). Finally, new Rule 16b-3 explicitly amended an earlier legislative rule. *See* 995 F.2d at 1112.

#### **B. The Decision Below Conflicts With This Court’s Retroactivity Jurisprudence**

The substantial and acknowledged conflicts among the courts of appeals discussed above are more than sufficient to warrant this Court’s review. Plenary review in this case is particularly appropriate, however, because the Third Circuit’s decision affirming the SEC’s obvious efforts to dictate the outcome of pending litigation and to alter the legal consequences of past conduct is deeply flawed: it conflicts with this Court’s decisions and undermines the purposes animating *Bowen* and *Landgraf*.

In holding that new Rule 16b-3 could apply retroactively — both in exempting respondents’ past short-swing trading from liability and in unsettling petitioner’s expectations based on the Third Circuit’s

holding in *Levy I* — the court of appeals erred in at least three respects.

*First*, the Third Circuit erred in holding that the contradiction between a rule and an earlier court of appeals' decision does not implicate problems of retroactivity. See Pet. App. 18a-19a. *Landgraf* held that "settled expectations should not be lightly disrupted," 511 U.S. at 265, and that the heart of the anti-retroactivity norm is that a new rule must not "attach[] new legal consequences to events completed before its enactment," *id.* at 270. A conflict between a court of appeals' decision and a clarifying agency rule implicates all of those concerns.

This case is directly on point. In *Levy I*, there was "no dispute" with respect to three of the four elements of liability under Section 16(b) — namely, that respondents were insiders that engaged in "sales" within six months of alleged "purchases." Pet. App. 70a. The issue, the Third Circuit said, was whether the purchases were exempt under the SEC's rules. See *id.* The court held that Rule 16b-3 required "some compensatory nexus" for the exemption to apply and that, because the short-swing transactions of respondents (which occurred in 2000) did not have a compensatory nexus, "the rule is inapplicable here." *Id.* at 97a-98a.

*Levy I* accordingly not only created expectations, but also adjudicated rules of liability under Section 16(b). Although this Court cautioned in *Landgraf* that a retroactivity problem does not necessarily arise because a new rule "upsets expectations based in prior law," 511 U.S. at 269, it emphasized that the dispositive issue is whether a new rule attaches or alters substantive *legal consequences* of earlier conduct, *id.* at 270. Here, the Third Circuit in *Levy I*

held that respondents' short-swing transactions in 2000 were subject to Section 16(b) and did not qualify for an exemption. That holding fixed the parties' rights and liabilities under the law with respect to the relevant short-swing transactions. Applying new Rule 16b-3 accordingly did more than unsettle the parties' expectations; it altered legal liabilities that a court of appeals had adjudicated. *Accord Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939, 948 (1997) (amendment that "eliminate[d]" an affirmative "defense" to suit has retroactive effect when applied to prior conduct).<sup>3</sup>

*Second*, the holding that clarifying rules are categorically exempt from the *Bowen* rule is deeply flawed. Although "it may be possible to generalize about types of rules that ordinarily will not raise retroactivity concerns," this Court has made clear that "these generalizations do not end the inquiry." *Martin v. Hadix*, 527 U.S. 343, 359 (1999). A judgment whether a rule is legislative/interpretive, procedural/substantive, or clarifying/amending is accordingly the beginning, not the end, of retroactivity analysis. *See id.* ("When determining whether a new statute operates retroactively, it is not enough to attach a label (e.g., 'procedural,' 'collateral') to the

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<sup>3</sup> *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005), does not affect this analysis. The Court held there that "[a] court's prior judicial construction of a statute" does not bind a subsequent agency interpretation. *Id.* at 982. The case did not involve agency rulemaking (the question arose from an agency adjudication), and there was no issue of retroactive application presented. The Court accordingly said nothing about the issue here — namely, under what circumstances a subsequent agency rule that conflicts with a prior court of appeals' decision can be applied to conduct predating promulgation of the rule.

statute; we must ask whether the statute operates retroactively.”); *see also Landgraf*, 511 U.S. at 269-70. The Third Circuit’s conclusion that clarifying rules can never have a retroactive effect — and therefore that *Landgraf* analysis need not be undertaken — countermands this Court’s teaching that “categorical arguments are not particularly helpful in undertaking *Landgraf*’s commonsense, functional retroactivity analysis.” *INS v. St. Cyr*, 533 U.S. 289, 324 (2001).

The Third Circuit’s application of an erroneous legal standard, predictably, led to an erroneous result. In this case, the purportedly clarifying Rule 16b-3 transformed the nature of respondents’ liability under Section 16(b), an issue effectively decided in *Levy I*. Therefore, regardless of whether new Rule 16b-3 can be deemed a clarification of prior law, the rule affected primary conduct and the legal consequences that attach to such conduct. In failing to acknowledge the continuing relevance of the *Landgraf* framework, the decision below conflicts with this Court’s retroactivity jurisprudence.

*Third*, the court erred in holding that the distinction between legislative and interpretive rules has “no bearing on whether a rule has an impermissible retroactive effect.” Pet. App. 28a n.10. Legislative rules, by their nature, have legal effect, “bind members of the agency and the public,” and receive “substantial deference from courts.” *Sweet v. Sheahan*, 235 F.3d 80, 91 (2d Cir. 2000). Legislative rules are “powerful” and “can impose obligations on members of the public distinct from, and in addition to, those imposed by statute.” *Id.*; *see also National Ass’n of Home Builders v. United States Army Corps of Eng’rs*, 417 F.3d 1272, 1285 (D.C. Cir. 2005) (“[l]egislative

rules are those that grant rights, impose obligations, or produce other significant effects on private interests”) (internal quotation marks omitted). Because the difference between legislative and interpretive rules bears directly on the nature and extent of change in the legal landscape wrought by a rule, the distinction is plainly relevant to retroactivity analysis. See *Landgraf*, 511 U.S. at 270 (in determining whether a law has retroactive effect, a “court must ask whether the new provision attaches new *legal consequences* to events completed before its enactment,” which is a judgment that “comes at the end of a process of judgment concerning *the nature and extent of the change in the law*”) (emphases added).

### C. This Case Is An Appropriate Vehicle To Address These Important Legal Issues

This case presents substantial jurisprudential issues of great practical importance. Taken together, *Bowen* and *Landgraf* impose important restraints on the authority of agencies to promulgate rules with retroactive effect. The decision below, as well as those of courts of appeals that have aligned themselves with the Third Circuit, will encourage agencies to circumvent this Court’s decisions by classifying their actions as “clarifications” subject to neither the *Bowen* rule nor the *Landgraf* retroactivity principles.

As a practical matter, allowing that erosion of *Bowen* and *Landgraf* to continue will afford agencies increasing latitude to manipulate the outcome of pending litigation and to alter the legal consequences of past conduct through mere regulatory fiat. Those outcomes directly conflict with the core principles animating the longstanding presumption against retroactivity. See, e.g., *Landgraf*, 511 U.S. at 265-



66; *Eastern Enters.*, 524 U.S. at 532-33 (plurality) (collecting authority); *St. Cyr*, 533 U.S. at 315 (noting that “[r]etroactive statutes raise special concerns” because of risk that “political pressures” will “tempt[]” decisionmakers “to use retroactive legislation as a means of retribution against unpopular groups or individuals”). Given the fundamental values advanced by retroactivity rules, this Court’s review here is needed to bring uniformity and to secure clarity with respect to when agency rules are in fact retroactive and therefore subject to *Bowen*’s proscription of retroactive rulemaking.

This case is an ideal vehicle for this Court to address these issues. It squarely presents three related conflicts, each of which is likely outcome-determinative here. The issues presented are pure questions of law that involve, among other things, the proper application of this Court’s decisions in *Bowen* and *Landgraf*. The legal issues, moreover, were fully briefed before the district court and the court of appeals, and passed upon by the lower courts. There is accordingly no reason for this Court to delay in resolving the important questions presented.

## II. THE THIRD CIRCUIT’S HOLDING THAT CONGRESS DELEGATED TO THE SEC NEAR PLENARY AUTHORITY TO EXEMPT TRANSACTIONS FROM SECTION 16(b) WARRANTS REVIEW BY THIS COURT

The Third Circuit held that new Rule 16b-3, which exempts all transactions between either officers or directors and issuers regardless of a compensatory purpose from the prohibition on short-swing transactions, “is a permissible construction of section 16(b) and a valid exercise of the SEC’s congressionally

delegated authority.” Pet. App. 24a. That judgment is incorrect: Congress did not provide the SEC plenary authority to exempt transactions from Section 16(b); rather, any exemption must be “comprehended within the purpose” of that section. 15 U.S.C. § 78p(b). Section 16(b)’s purpose is to prohibit *any* profiteering from short-swing transactions, not merely to ban transactions involving informational asymmetries. Because new Rule 16b-3 creates an exemption that is contrary to, and not “comprehended within,” the purpose of Section 16(b), the Third Circuit erred in concluding that the rule is a valid exercise of delegated authority. That error affects a crucial regulation of market practices that could negatively affect the stability of the markets and thus warrants this Court’s attention.

#### **A. The SEC’s New Rule 16b-3 Conflicts With The Purposes Of Section 16(b)**

Congress intended Section 16(b) broadly to prevent all profiteering from short-swing transactions. Section 16(b) provides the SEC only limited authority to exempt from the statute’s reach those transactions that are “not comprehended within the purpose” of the section. 15 U.S.C. § 78p(b). Because the text and history of Section 16(b), as well as judicial decisions interpreting that provision, make clear that Congress’s overriding objective was to curb nearly all short-swing insider transactions, including the type of short-swing trading that occurred here, new Rule 16b-3 is an invalid exercise of the SEC’s authority.

1. A proper understanding of Section 16(b)’s purpose must begin from the presumption that Congress intended the securities laws to advance “broad remedial goals.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976). Although “[t]he ultimate question is

one of congressional intent," *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979), this Court has time and again observed that "Congress intended securities legislation . . . to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)).

Viewed against that background understanding, the statutory text strongly indicates that Congress intended for Section 16(b) to reach broadly the type of speculative short-swing transactions that took place here. The prohibition in Section 16(b) is notable both in its breadth and in its mandatory nature: under that section, "any profit" that an insider acquires from a transaction "within any period of less than six months . . . shall inure to and be recoverable by the issuer" without regard to the "intention" of the insider. 15 U.S.C. § 78p(b) (emphases added).

Moreover, the Exchange Act's structure supports the conclusion that the SEC has only limited authority to create exemptions from Section 16(b). Unlike many other provisions of the Exchange Act, Section 16(b) is noteworthy for its rigidity and the fact that it left virtually no room for interpretation or interference by the SEC. See *Thel*, 42 Hastings L.J. at 400-01; see also Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 Ga. L. Rev. 183, 227 (1992) (noting that, "[w]hile the other provisions" of the Exchange Act "are generally not self-implementing, section 16 contains substantive prohibitions which do not require administrative



rulemaking for implementation").<sup>4</sup> Indeed the SEC has no independent authority to enforce Section 16(b). See *Gollust v. Mendell*, 501 U.S. 115, 122 (1991).

2. The legislative history bolsters the conclusion that Section 16(b) is intended to curb *speculation* and to do so by banning *all* short-swing trades by insiders. The Exchange Act's authors viewed speculation as one of the principal evils contributing to the 1929 stock market crash. See Okamoto, 27 Ga. L. Rev. at 222-24; Thel, 42 Hastings L.J. at 458-59. In enacting the statute, "Congress' goal was to restore eroded investor confidence in the integrity of the market, and the technique it chose was a sweeping removal of any profit motive for . . . 'sure-thing' speculation." *Wagman v. Astle*, 380 F. Supp. 497, 501 (S.D.N.Y. 1974). Section 16(b) was a major provision of the securities law reform movement of the 1930s, and its forfeiture requirement was intended to apply broadly and unambiguously as a prophylactic. See *Lewis v. Varnes*, 505 F.2d 785, 787-88 (2d Cir. 1974).

Section 16(b) was thus designed "to discourage insiders from buying stock, but not so much from

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<sup>4</sup> The first sentence of Section 16(b), moreover, sets forth part of the statutory purpose — namely, "preventing the unfair use of information which *may* have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer." 15 U.S.C. § 78p(b) (emphasis added). The text makes clear that the prohibition in Section 16(b) is not confined simply to trading on non-public information; rather, it reaches *all* insiders regardless of whether they have made use of inside information. Indeed, new Rule 16b-3 conflicts with even a narrow understanding of Section 16(b) as limited to addressing the improper use of inside information because the new rule permits an insider to profit from that information through transactions in company stock and provides the insider with an incentive to manipulate company affairs so as to take advantage of price fluctuations.

buying on inside information as from buying on speculation." Thel, 42 Hastings L.J. at 414. Congress viewed short-swing trading by insiders as an evil in itself, rife with potential for manipulation. Such manipulation had led to price volatility, often sending false signals about the value of companies, which in turn rattled investor confidence and allowed insiders to exploit artificially depressed prices. See Okamoto, 27 Ga. L. Rev. at 226.

The legislative history therefore evinces a broad concern with curbing short-swing transactions by insiders. For instance, Senator Duncan Fletcher, who sponsored the Exchange Act, noted that Section 16(b) would forbid "directors, officers, and principal stockholders . . . to speculate in the securities of [their own] corporation." 78 Cong. Rec. 2270, 2271 (1934). Similarly, Thomas Corcoran explained the bill's primary purpose as preventing "short-term speculative swings on the securities of [insiders'] own companies." *Stock Exchange Practices: Hearings on S. Res. 84 (72d Congress) and S. Res. 56 and S. Res. 97 (73d Congress) Before the S. Comm. on Banking and Currency*, 73d Cong. 6556-57 (1934). Accordingly, Corcoran explained that the element of intent or expectation had been dropped from the original draft of the bill, so as to prevent *all* short-swing trades and to mandate forfeiture of *all* short-swing profits. See *id.*

3. This Court's decisions strengthen the conclusion that Section 16(b)'s "purpose" is to prevent short-swing trading, writ large, by insiders. The Court has repeatedly acknowledged the statute's dual purposes: (1) preventing *insider trading* (that is, trading on non-public information) by officers, directors, and principal beneficial owners; and (2) preventing *short-*

*swing trading* by officers, directors, and beneficial owners. In *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418 (1972), for example, this Court noted that Section 16(b) sweeps far more broadly than simply preventing insiders from trading on non-public information (as the SEC and the Third Circuit assumed):

In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.

*Id.* at 422 (internal quotation marks omitted). This Court has repeatedly underscored that Congress sought broadly to “curb[] short-swing speculation,” *id.* at 424, and to “impose[] liability without fault,” *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 251 (1976). Against that backdrop, *Levy* *I* correctly interpreted Rule 16b-3’s exemption narrowly. *See* Pet. App. 97a-98a.

For these reasons, the text and history of Section 16(b), as well as this Court’s decisions interpreting it, establish that Section 16(b)’s “purpose” is to prevent any profiteering on short-swing transactions. Because the “intent of Congress is clear” with regard to the “purpose” of the statute, “that is the end of the matter.” *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). Congress

intended for Section 16(b) to cover the conduct at issue here: short-swing trading by an insider.

New Rule 16b-3, which is premised on the view that Section 16(b) is aimed only at transactions involving information asymmetries, therefore represents an unlawful construction of Section 16(b)'s "purpose." Indeed, new Rule 16b-3 undermines both of the core purposes of Section 16(b) by enabling insiders to engage in trading on inside information in their own company's stock and by creating incentives for insiders to manipulate their company's affairs to benefit from price fluctuations. The Third Circuit erred in according *Chevron* deference to the SEC's enactment of that rule pursuant to Section 16(b).<sup>5</sup>

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<sup>5</sup> Once the purpose of Section 16(b) is properly understood, the SEC's justifications for new Rule 16b-3 are unresponsive. For example, in promulgating new Rule 16b-3, the SEC explained that transactions between insiders and issuers do not usually present opportunities for insiders to realize profits at the expense of uninformed shareholders. See 70 Fed. Reg. at 46,083. But that is beside the point: Section 16(b)'s primary purpose is not to function as a remedial statute for shareholders or to guard against informational asymmetries but to promote market stability by banning profiteering from all short-swing transactions.

The SEC also relied on the requirement of obtaining board approval to argue that the transactions in question do not present a risk of speculative abuse. See *id.* at 46,082. But the SEC has never explained how this gate-keeping function will prevent the kind of speculation that the statute and its drafters sought to prevent. Moreover, in enacting Section 16(b), Congress specifically denied boards of directors the ability to prevent shareholder lawsuits to recover short-swing profits. Accord *Burks v. Lasker*, 441 U.S. 471, 484 n.13 (1979).

## **B. The Court Should Grant Certiorari To Clarify The Scope Of An Important Provision Of Securities Law**

New Rule 16b-3 threatens to undermine the efficacy of an important and longstanding securities regulation. Instead of construing Section 16(b) as Congress intended, the SEC has adopted a narrow understanding of Section 16(b)'s purposes that will invite the very behavior that Congress sought to prevent. The prevalence of short-swing trading and the increasing importance of securities regulation militate in favor of this Court's intervention now to clarify an important area of securities law.

Given the important functions served by Section 16(b), this Court's intervention is crucial to ensure that Rule 16b-3 does not undermine the statute's principal purpose of preventing short-swing trading and speculative manipulation by insiders. Particularly in the current economic climate, clarity regarding the scope and import of securities laws is of paramount importance.

## **CONCLUSION**

The petition for a writ of certiorari should be granted.

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## **APPENDIX**



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UNITED STATES COURT OF APPEALS  
FOR THE THIRD CIRCUIT

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No. 07-1849

MARK LEVY,  
*Appellant,*  
v.

STERLING HOLDING COMPANY, LLC;  
NATIONAL SEMICONDUCTOR CORPORATION;  
FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,  
*Appellees.*

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Argued March 24, 2008

Filed: Oct. 1, 2008

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Before: McKEE, RENDELL, and TASHIMA,\*  
Circuit Judges.

OPINION OF THE COURT

RENDELL, Circuit Judge.

Mark Levy filed a shareholder derivative suit on behalf of Fairchild Semiconductor International, Inc. ("Fairchild") against Sterling Holding Company, LLC ("Sterling") and National Semiconductor Corporation ("National") for disgorgement of short-swing profits, pursuant to section 16(b) of the Exchange Act of

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\* Honorable A. Wallace Tashima, Senior Judge of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

1934. National and Sterling contend that two separate SEC Rules, 16b-3 and 16b-7, exempt them from section 16(b) liability. When this case was before us previously, at the motion-to-dismiss stage, we ruled that neither exemption applied here. *Levy v. Sterling Holding Co. (Levy I)*, 314 F.3d 106 (3d Cir.2002). Thereafter, however, the SEC amended Rules 16b-3 and 16b-7 to, as it put it, “clarify the exemptive scope” of these two Rules, making clear that both apply to the instant fact pattern. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 52,202 (“2005 Amendments Release”), 70 Fed.Reg. 46,080, 46,080 (Aug. 9, 2005). The District Court then ruled in favor of National and Sterling and against Levy on cross motions for summary judgment. We must decide whether our rulings in *Levy I*, or the SEC’s more-recent Rule amendments, govern the case at this stage. For the reasons that follow, we conclude that at least one of the amendments is controlling and, therefore, we will affirm the District Court’s grant of summary judgment to National and Sterling, and its denial of summary judgment to Levy.

## I.

### A.

In 1997, Fairchild was spun off from National as a new company. Three classes of Fairchild stock were created: (1) Class A common stock; (2) Class B common stock, which differed from Class A common because it did not entail voting rights; and (3) preferred stock, which offered a cumulative 12% dividend. Class A common and Class B common were freely convertible into each another, but preferred stock was not convertible into either Class of common. National received a mix of all three classes of

stock and, in exchange for its \$58.5 million investment in the new company, so did Sterling. The only other initial investors were a number of National employees slated to become key Fairchild employees. The governing shareholder agreement gave National the power to designate one of Fairchild's seven directors and gave Sterling the power to designate two.

In 1999, Fairchild decided to undertake an initial public offering ("IPO") to raise additional capital and was told by a number of underwriters that it should eliminate its preferred stock in order for the IPO to be successful. Consistent with this advice, a majority of Fairchild's board voted that, as part of the IPO, all of the company's outstanding shares of preferred stock would automatically be reclassified as shares of Class A common stock. A majority of each of the three classes of shareholders subsequently approved the reclassification by written consent. Preferred shares were to be valued at their contractual liquidation value – the original price plus accumulated unpaid dividends – and Class A common shares were to be valued at the price at which the Class A shares would be offered to the public in the IPO, less underwriting fees and commissions. Dividing the former by the latter yielded a 76-to-1 conversion ratio, meaning that each share of preferred stock would become 76 shares of Class A common.<sup>1</sup> Prior to the execution of the IPO, according to the IPO prospectus, Sterling owned 48% of the outstanding Class A common, 85.1% of the outstanding Class B common, and 75.9% of the outstanding preferred, while National owned 14.8%, 14.9%, and 16.7%, respectively.

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<sup>1</sup> We have rounded off the figures throughout this opinion because the precise figures are unimportant.

On August 9, 1999, the IPO was completed and the shares of preferred stock owned by Sterling and National were reclassified as 4 million and 900,000 shares of Class A common, respectively. On January 19, 2000 – less than six months later – with Fairchild undertaking a secondary offering of Class A common stock, Sterling sold 11 million shares of Class A common and National sold 7 million shares of Class A common. The share price of Class A common had increased 84% since the reclassification.

### B.

In November 2000, Levy, a Fairchild shareholder, filed a derivative suit against National and Sterling, pursuant to section 16(b) of the Securities and Exchange Act of 1934, which generally provides for the disgorgement of any profits earned by statutory insiders from short-swing trading. See 15 U.S.C. § 78p(b).<sup>2</sup> The four elements required for section

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<sup>2</sup> Section 16(b) provides, in pertinent part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement . . . involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time

16(b) liability are (1) a purchase of a security and (2) a sale of that security (3) by a director or officer of the issuer or by a beneficial owner of 10% of any Class of the issuer's securities (4) within a six-month period. *See id.*; *Levy I*, 314 F.3d at 111. As a general rule, any profits earned through transactions that meet these elements rightfully belong to the issuer. There is no *mens rea* requirement – section 16(b) creates a strict liability regime.

According to the statute itself, the purpose of section 16(b) is “preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.” 15 U.S.C. § 78p(b). The statute authorizes the SEC to promulgate rules and regulations exempting from liability transactions that are “not comprehended within [this] purpose.” *Id.*; *see Levy I*, 314 F.3d at 112. Exercising this authority, the SEC has established a number of section 16(b) exemptions. *See* 17 C.F.R. §§ 240.16b-1, .16b-3, .16b-5 to .16b-8 (codifying SEC Rules 16b-1, 16b-3, and 16b-5 to 16b-8).

Levy claimed that the reclassification of National's and Sterling's preferred stock holdings constituted a “purchase” of Class A common stock so that the profits that National and Sterling earned from their sale of Class A common less than six months later belong to Fairchild. National and Sterling filed motions to dismiss, contending that two separate

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of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement . . . involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b).



exemptions – Rule 16b-3 and Rule 16b-7 – shielded them from section 16(b) liability.<sup>3</sup>

Adopted in 1996, the version of Rule 16b-3 that was in effect until 2005 provided, in pertinent part:

Transactions between an issuer and its officers or directors.

(a) General. A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

....

(d) Grants, awards and other acquisitions from the issuer. Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

- (1) The transaction is approved by the board of directors of the issuer . . . ;
- (2) The transaction is approved or ratified by . . . the written consent of the holders of a majority of the securities of the issuer entitled to vote . . . ; or

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<sup>3</sup> National and Sterling also maintained – and continue to maintain – that, under the so-called “unorthodox transaction” doctrine, the reclassification did not constitute a “purchase” for section 16(b) purposes. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593-94, 93 S.Ct. 1736, 36 L.Ed. 2d 503 (1973). We will refrain from addressing this argument because our analysis of Rules 16b-3 and 16b-7 below makes it unnecessary for us to do so.

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition . . . .

17 C.F.R. § 240.16b-3 (amended 2005).

The 1991 version of Rule 16b-7, which remained in effect until 2005, provided, in pertinent part:

Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger or consolidation . . . .

17 C.F.R. § 240.16b-7 (amended 2005). Even though the SEC added the word “reclassifications” to the Rule’s title in 1991, the Rule’s text did not specifically refer to them.

National and Sterling argued that Rule 16b-3(d) exempted them from any liability related to the reclassification because the reclassification fit within the category of a “grant, award, or other acquisition from the issuer” – as an “other acquisition” – and was approved by a majority of Fairchild’s board and a majority of the voting shareholders (even though approval by either of the two would have sufficed). They maintained that Rule 16b-7’s exemption applied

as well because they acquired the disputed Class A common stock as part of a "reclassification" that met the Rule's 85% cross-ownership requirement.

The District Court granted National's and Sterling's motions to dismiss, finding that the reclassification fell within the scope of Rule 16b-7 and that Levy's section 16(b) suit thus necessarily failed. The Court did not rule on the applicability of Rule 16b-3(d). Levy then appealed to our Court.

### C.

In an opinion filed December 19, 2002, we reversed, concluding that neither Rule 16b-3(d) nor Rule 16b-7 exempted National or Sterling from section 16(b) liability. As to Rule 16b-3(d), we reasoned that, despite the apparent open-endedness of the language "other acquisition from the issuer," and despite the fact that the Rule made no mention of "compensation," the SEC intended it to apply only to transactions with a compensatory nexus. *Levy I*, 314 F.3d at 120-24. We reviewed in depth the release issued by the SEC in 1996 in connection with the adoption of the Rule, and relied on a number of excerpts that, we thought, indicated that the SEC adopted the 1996 version of the Rule in order to spur participation in employee benefit plans and to make it clear that the exemption applied to participant-directed transactions, such as the exercise of a stock option. *Id.* at 122-24. We did acknowledge, however, that one portion of the release "appear[ed] to cut against our position" that Rule 16b-3(d) required a compensatory nexus. *Id.* at 124. In that portion, the SEC explained:

New Rule 16b-3 exempts from short-swing profit recovery any acquisitions and dispositions of issuer equity securities . . . between an officer or

director and the issuer, subject to simplified conditions. A transaction with an employee benefit plan sponsored by the issuer will be treated the same as a transaction with the issuer. However, unlike the current rule, *a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element.*

Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 37,260 ("1996 Rule 16b-3 Release"), 61 Fed.Reg. 30,376, 30,378-79 (June 14, 1996) (emphasis added) (footnotes omitted). Nonetheless, we concluded that "the weight of the SEC's pronouncements on Rule 16b-3, and particularly Rule 16b-3(d), suggest that the transaction should have some connection to a compensation-related function." *Levy I*, 314 F.3d at 124.

Examining the applicability of the exemption set forth in Rule 16b-7, we began our analysis by noting that "the SEC has not set forth its interpretation clearly so our threshold challenge is to ascertain what in fact was its interpretation." *Id.* at 112. We reasoned that the SEC must have added "reclassifications" to the Rule's title for a reason, but found that, "[u]nfortunately, . . . the title and text of the rule, standing alone, do not provide us assistance in our effort to ascertain the SEC's purpose." *Id.* at 113.

Based on a pair of SEC releases, we concluded that the SEC intended for Rule 16b-7 to exempt some, but not all, reclassifications from section 16(b) liability. *Id.* at 113-15. The first release was from 1981 (i.e., ten years before "reclassifications" was added to the Rule's title) and included a question and answer regarding the Rule's applicability to reclassifications:

Question: Although not specifically mentioned, does Rule 16b-7 apply to transactions structured as (1) statutory exchanges; (2) liquidations; or (3) *reclassifications*?

Answer: The staff is of the view that, for purposes of Rule 16b-7, a statutory exchange may be the substantive equivalent of a merger, consolidation or sale of assets. Therefore, the acquisition and disposition of stock in a statutory exchange would be exempt under Rule 16b-7, assuming all of the conditions of the rule are satisfied. A liquidation, on the other hand, is not covered by Rule 16b-7, since the liquidation in substance and purpose bears little resemblance to the types of transactions specified in the rule. Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and *the rule can apply to transactions involving reclassifications.*

Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18,114, 46 Fed.Reg. 48,147, 48,176-77 (Oct. 1, 1981) (emphasis added) (footnotes omitted). Essentially, we read the language "can apply" to mean "sometimes applies." *Levy I*, 314 F.3d at 113-14.

The second release, from 2002, pertained to proposed amendments to Form 8-K and exempted from reporting requirements "[a]cquisitions or dispositions pursuant to holding company formations and similar corporate *reclassifications* and consolidations." Form 8-K Disclosure of Certain Management Transactions, Exchange Act Release No. 45,742, 67 Fed.Reg. 19,914, 19,919 (Apr. 23, 2002) (emphasis added). It noted that "[t]hese are the transactions exempted from Section 16(b) short-swing profit recovery by



Exchange Act Rule 16b-7.” *Id.* at 19,919 n. 56. We reasoned that this release “does not suggest that all reclassifications are *per se* exempt” and that, because it “clearly hedges on the point,” it “thus supports a conclusion that some but not all reclassifications are exempt from section 16(b)’s restrictions.” *Levy I*, 314 F.3d at 114.

Next, lacking “specific SEC guidance about which reclassifications are exempt from section 16(b) under Rule 16b-7,” we devised a two-part test, under which a particular reclassification would be exempt if it (1) met the 85% cross-ownership requirements that the Rule clearly made applicable to mergers and consolidations and (2) was a transaction “not comprehended within the purpose” of section 16(b). *Id.* at 114-15 (quoting 15 U.S.C. § 78p(b)).

Applying our newly-created test, we found that the reclassification here failed part two—at least at the motion-to-dismiss stage. *Id.* at 115-18. We rejected National and Sterling’s argument that the reclassification changed only the form, not the substance, of their investments in Fairchild such that it did not present an opportunity for insiders to benefit over the public and thus did not implicate Congress’s purpose in enacting section 16(b). Indeed, we concluded that it did present such an opportunity. We based our conclusion on two independent grounds. First, we found that, reading the pleadings in the light most favorable to Levy, the reclassification proportionately increased National’s and Sterling’s interests in Fairchild by leaving them with a greater percentage of Fairchild’s common stock. *Id.* at 116-17. Second, after contrasting the pros and cons of common-stock and preferred-stock ownership, we decided that the reclassification “so chang[ed] the



risks and opportunities of the preferred shareholders in [Fairchild<sup>4</sup>] that the SEC would not have intended to exempt the reclassification from section 16(b) by Rule 16b-7." *Id.* at 117-18.

National and Sterling petitioned for rehearing, and the SEC submitted an amicus brief in support. We denied the rehearing request, despite the fact that the SEC maintained in its brief that our ruling in *Levy I* was inconsistent with its view that both exemptions applied here.<sup>5</sup>

#### D.

In 2005, in response to our opinion in *Levy I*, the SEC adopted amendments to Rules 16b-3 and 16b-7 in order "to clarify the exemptive scope of these rules, consistent with statements in previous Commission releases." 2005 Amendments Release, 70 Fed.Reg. at 46,080. The SEC explained its disagreement with *Levy I* and its impetus for the amendments in the adopting release:

In particular, the *Levy v. Sterling* opinion read Rules 16b-3 and 16b-7 to require satisfaction of conditions that were neither contained in the text of the rules nor intended by the Commission. The resulting uncertainty regarding the exemptive scope of these rules has made it difficult for issuers and insiders to plan legitimate transactions, and may discourage participation by

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<sup>4</sup> While we wrote "National and Sterling" here, the context makes clear that this was a mistake and that we meant to write "Fairchild."

<sup>5</sup> Despite Levy's contention to the contrary, "[t]he failure of a petition to achieve the necessary votes for rehearing does not . . . imply any judgment on the merits and has no jurisprudential significance." *In re Grand Jury Investigation*, 542 F.2d 166, 173 (3d Cir.1976).

officers and directors in issuer stock ownership programs or employee incentive plans. With the clarifying amendments to Rules 16b-3 and 16b-7 that we adopt today, we resolve any doubt as to the meaning and interpretation of these rules by reaffirming the views we have consistently expressed previously regarding their appropriate construction.

*Id.* at 46,081.

Rule 16b-3 (d) was amended to read, in pertinent part:

(d) *Acquisitions from the issuer.* Any transaction, other than a Discretionary Transaction, involving an acquisition [by an officer or director] from the issuer (*including without limitation a grant or award*), *whether or not intended for a compensatory or other particular purpose*, shall be exempt if [one of the same three conditions from the 1996 version of the Rule are met].

17 C.F.R. § 240.16b-3(d) (new material underlined). Thus, there is now no doubt that Rule 16b-3(d) does *not* require a compensatory nexus.

Rule 16b-7 was amended to read, in pertinent part:

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger, *reclassification* or consolidation, in exchange for a security of a company *that before the merger, reclassification or consolidation, owned 85 percent or more of either:*

(i) The equity securities of all other companies involved in the merger, *reclassification*, or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger, *reclassification*, or consolidation....

....

(c) *The exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions.*

17 C.F.R. § 240.16b-7 (new material underlined). Thus, there is no now no doubt that Rule 16b-7 applies to any reclassification that meets the Rule's 85% cross-ownership requirement.

Further, the SEC explicitly indicated that "because [the Rule 16b-3 amendments] clarify regulatory conditions that applied to [that exemption] since [it] became effective on August 15, 1996, they are available to any transaction on or after August 15, 1996 that satisfies the regulatory conditions so clarified." 2005 Amendments Release, 70 Fed.Reg. at 46,080. The SEC similarly made clear its view that "because [the Rule 16b-7 amendments] clarif[y] regulatory conditions that applied to that exemption since it was amended effective May 1, 1991, [they are] available to any transaction on or after May 1, 1991 that satisfies the regulatory conditions so clarified." *Id.* The transaction at issue here occurred in August 1999 – well after both of these dates, but six years before the adoption of the "clarifying" regulations.

### E.

Before the adoption of the 2005 amendments, Levy, National, and Sterling had filed cross motions for summary judgment. After the amendments were adopted, the District Court denied Levy's motion and

granted those of National and Sterling, finding that the new versions of both Rules applied to the 1999 reclassification and shielded National and Sterling from section 16(b) liability. *Levy v. Sterling Holding Co.*, 475 F.Supp.2d 463 (D.Del.2007). Specifically, the Court concluded that the new Rules were permissible constructions of section 16(b), *id.* at 470-74, and that applying them here would have no impermissible retroactive effect because the changes made to the old Rules were "clarifying" rather than "substantive," *id.* at 475-78. Levy then filed this timely appeal.

## II.

The District Court had jurisdiction pursuant to 15 U.S.C. § 78aa and 28 U.S.C. § 1331, and we now have appellate jurisdiction pursuant to 28 U.S.C. § 1291.<sup>6</sup> We review *de novo* the grant or denial of summary judgment by a district court. *Abramson v. William Paterson Coll. of N.J.*, 260 F.3d 265, 276 (3d Cir. 2001). Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c).

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<sup>6</sup> Although denials of summary judgment usually are not appealable, we have repeatedly made clear that "'when an appeal from a denial of summary judgment is raised in tandem with an appeal of an order granting a cross-motion for summary judgment, we have jurisdiction to review the propriety of the denial of summary judgment by the district court.'" *Transportes Ferreos de Venezuela II CA v. NKK Corp.*, 239 F.3d 555, 560 (3d Cir.2001) (quoting *Nazay v. Miller*, 949 F.2d 1323, 1328 (3d Cir.1991)).

## III.

Levy raises three issues on appeal. First, he maintains that, under the doctrine of *stare decisis*, the mandate that we issued in *Levy I* requires the grant of summary judgment in his favor. Second, Levy contends that new Rule 16b-3 and new Rule 16b-7 both exceed the authority that Congress delegated to the SEC in section 16(b). Third, he asserts that applying either of the new Rules to exempt National's or Sterling's acquisition of Class A common stock through Fairchild's 1999 reclassification would have an impermissible retroactive effect. Levy does not argue, however, that the transactions at issue failed in any way to meet the requirements of the *new* Rules. Thus, he has effectively conceded that if we were to conclude that either of the new Rules is a permissible exercise of the SEC's authority that may properly be applied to a 1999 reclassification, we would affirm the District Court's grant of summary judgment to National and Sterling and its denial of his motion for summary judgment.

## A.

Levy argues that the following three premises, together, require the grant of summary judgment in his favor: (1) all four elements of a section 16(b) violation were met by both National and Sterling; (2) we already ruled in *Levy I* that neither Rule 16b-3 nor Rule 16b-7 exempted National or Sterling from liability; and (3) prior panel decisions may only be overruled by our Court sitting en banc, which has not happened here. Even assuming that these premises are correct, however, Levy's proposed conclusion does not follow from them.

In *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967, 125

S.Ct. 2688, 162 L.Ed.2d 820 (2005), the Supreme Court left no doubt that if a court of appeals interprets an ambiguous statute one way, and the agency charged with administering that statute subsequently interprets it another way, even that same court of appeals may not then ignore the agency's more-recent interpretation. In 2000, the United States Court of Appeals for the Ninth Circuit held that broadband cable Internet service constituted a "telecommunications service" under Title II of the Communications Act, a classification with significant regulatory implications. *Id.* at 979-80, 125 S.Ct. 2688. In 2002, however, the Federal Communications Commission ("FCC") issued a declaratory ruling that the term "telecommunications service" *did not* encompass broadband cable Internet service. *Id.* at 977-78, 125 S.Ct. 2688. When numerous parties challenged the FCC ruling, the Ninth Circuit held, under principles of *stare decisis*, that it was bound by its interpretation of "telecommunications service," notwithstanding the FCC's conflicting interpretation from two years later. *Id.* at 979-80, 125 S.Ct. 2688.

The Supreme Court reversed, explaining that "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference<sup>7</sup> only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." *Id.* at 982, 125 S.Ct. 2688. The Court reasoned that "allowing a judicial precedent to fore-

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<sup>7</sup> As discussed below, under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, courts generally must accord great deference to an agency's interpretation of a statute that Congress has authorized it to administer. 467 U.S. 837, 842-43, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984).



close an agency from interpreting an ambiguous statute . . . would allow a court's interpretation to override an agency's," which would fly in the face of "*Chevron's* premise . . . that it is for agencies, not courts, to fill statutory gaps." *Id.* Further, the Court emphasized, the Ninth Circuit's approach "would produce anomalous results," as the relative weight of conflicting judicial and agency interpretations of an ambiguous statute "would turn on the order in which the interpretations issue." *Id.* at 983, 125 S.Ct. 2688; see also *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 744 n. 3, 116 S.Ct. 1730, 135 L.Ed.2d 25 (1996) ("Where . . . a court is addressing transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means."); *Reich v. D.M. Sabia Co.*, 90 F.3d 854, 858 (3d Cir.1996) ("Although a panel of this court is bound by, and lacks authority to overrule, a published decision of a prior panel, a panel may re-evaluate a precedent in light of intervening authority and amendments to statutes or regulations." (emphasis added) (citation omitted)).

We see no reason why these principles should not apply equally to the interpretation of a regulation. After all, "[w]hen the construction of an administrative regulation rather than a statute is in issue, deference is even more clearly in order." *Udall v. Tallman*, 380 U.S. 1, 16-17, 85 S.Ct. 792, 13 L.Ed.2d 616 (1965); see also *Facchiano Constr. Co. v. U.S. Dep't of Labor*, 987 F.2d 206, 213 (3d Cir.1993) ("[A]n administrative agency's interpretation of its own regulation receives even greater deference than that accorded to its interpretation of a statute."). Accordingly, we conclude that a judicial opinion con-

struing an agency's regulation does not necessarily bar a court from giving effect to a subsequent, different interpretation by the agency, unless, according to the earlier opinion, the judicial construction flowed unambiguously from the terms of the regulation. To find otherwise would produce the same "anomalous results" that the *Brand X* Court sought to avoid, creating a first-in-time rule for determining whether a judicial or administrative interpretation of a regulation is authoritative.

We reached a similar conclusion in a similar context in *United States v. Marmolejos*, 140 F.3d 488 (3d Cir.1998), a case that involved an amendment by the Sentencing Commission of an application note that accompanied an ambiguous section of the Sentencing Guidelines. There, we made clear that an earlier, conflicting judicial construction of the ambiguous Guidelines section did not preclude us from considering the more-recent interpretation of that section provided by the Commission in the application note amendment. *Id.* at 492-93 & n. 7. In such a situation, we explained, "this court is not bound to close its eyes to the new source of enlightenment." *Id.* at 493 (quoting *United States v. Joshua*, 976 F.2d 844, 855 (3d Cir.1992)). Importantly, as we noted in *Marmolejos*, the Supreme Court has analogized Sentencing Commission commentary on the Guidelines to an agency's interpretation of its own rules. *Id.* at 493 n. 7 (citing *Stinson v. United States*, 508 U.S. 36, 44-45, 113 S.Ct. 1913, 123 L.Ed.2d 598 (1993)).

Here, the new Rules constitute both (1) interpretations of a statute, as they construe the provision of section 16(b) granting the SEC authority to exempt transactions "not comprehended within [the statute's] purpose," and (2) interpretations of regulations, as

they set forth the SEC's understanding of what the old Rules meant all along. Looking at the new Rules from either perspective, it is clear that, notwithstanding the doctrine of *stare decisis*, *Levy I* does not necessarily foreclose us from considering them. In *Levy I*, we did not conclude that section 16(b) unambiguously precluded the SEC from exempting transactions like the 1999 reclassification. Similarly, we did not indicate that our reading of old Rule 16b-3 or of old Rule 16b-7 flowed unambiguously from their terms. Indeed, we struggled to divine their applicability to the instant fact pattern. With respect to Rule 16b-3, we concluded only that "the weight of the SEC's pronouncements . . . suggest[ed]" that we should read in a compensatory nexus requirement. *Levy I*, 314 F.3d at 124 (emphasis added). Further, we recognized that a portion of the SEC's adopting release "appear[ed] to cut against" this interpretation. *Id.* As to Rule 16b-7, we repeatedly noted the lack of clear guidance in the text or elsewhere regarding whether and to what extent reclassifications fell within the Rule's scope. *Id.* at 112-14. Our conclusion as to both represented our view of what the SEC probably intended.

Accordingly, *Levy I* does not control the result here simply by virtue of the fact that it came first and has not been overturned.

## B.

*Levy* also contends that new Rule 16b-3 and new Rule 16b-7 are improper exercises of the authority that Congress granted the SEC in section 16(b). This argument equates to a claim that both new Rules are impermissible interpretations of the portion of the statute that provides that section 16(b) does not apply to "any transaction or transactions which the

Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.” 15 U.S.C. § 78p(b). Because *Chevron* deference applies here, and the statutory interpretations embodied in the new Rules easily pass muster under this lenient standard, we disagree with Levy on this issue as well.

*Chevron* deference applies to an agency’s statutory interpretation “when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.” *United States v. Mead Corp.*, 533 U.S. 218, 226-27, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001). If we determine that the situation does indeed call for *Chevron* deference, we proceed to a two-step inquiry. First, we ask “whether Congress has directly spoken to the precise question at issue.” *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). If the answer is yes, we “must give effect to the unambiguously expressed intent of Congress” and our inquiry ends there. *Id.* at 842-43, 104 S.Ct. 2778. If, however, the answer is no, we move on to step two, under which we must give the agency’s interpretation “controlling weight” unless it is “arbitrary, capricious, or manifestly contrary to the statute.” *Id.* at 843, 104 S.Ct. 2778. In other words, where Congress has left a “statutory gap” for the agency to fill, we must accept any interpretation by the agency that fills the gap “in reasonable fashion.” *Brand X*, 545 U.S. at 980, 125 S.Ct. 2688.

Here, Congress has generally authorized the SEC to make rules that have the force of law in implementing the Exchange Act, Securities Exchange

Act of 1934 § 23(a), 15 U.S.C. § 78w(a), and has specifically authorized it to create binding exemptions from short-swing profit recovery, 15 U.S.C. § 78p(b). Because the SEC was acting pursuant to this authority when it promulgated new Rule 16b-3 and new Rule 16b-7, *Chevron* deference clearly applies. See 2005 Amendments Release, 70 Fed. Reg. at 46,084-85 & nn. 54, 71. Further, by broadly pronouncing that section 16(b) does not apply to “any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection,” 15 U.S.C. § 78p(b), Congress certainly left a gap for the agency to fill. Thus, the key question for us to answer is whether it was reasonable for the SEC to think that the transactions exempted by the new Rules are “not comprehended within the purpose” of section 16(b).

As noted above, section 16(b)’s self-proclaimed purpose is “preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.” 15 U.S.C. § 78p(b). The Supreme Court has expanded upon this purpose:

The general purpose of Congress in enacting s[ection] 16(b) is well known. Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, these persons could reap profits at the expense of less well informed investors. In s[ection] 16(b) Congress sought to “curb the evils of insider trading [by] . . . taking the profits out of a Class of transactions in which the possibility of abuse was believed to be intolerably great.” It



accomplished this by defining directors, officers, and beneficial owners as those presumed to have access to inside information and enacting a flat rule that a corporation could recover the profits these insiders made on a pair of security transactions within six months.

*Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243-44, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976) (alterations in original) (citations and footnotes omitted) (quoting *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422, 92 S.Ct. 596, 30 L.Ed.2d 575 (1972)).

In the 2005 adopting release, the SEC explained why it believed the transactions exempted by new Rule 16b-3 – transactions between directors or officers and the issuer – were not comprehended within this purpose:

Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute.

2005 Amendments Release, 70 Fed.Reg. at 46,083 (quoting 1996 Rule 16b-3 Release, 61 Fed.Reg. at 30,377).

In other words, the purchase of securities from, or sale of securities to, the issuer by a director or officer does not present the same informational asymmetry, and associated opportunity for speculative abuse, that, according to the Supreme Court, Congress was targeting in enacting section 16(b). Because this rationale is perfectly reasonable – and applies equally whether or not the transaction has a com-



pensatory nexus – we conclude that new Rule 16b-3 is a permissible construction of section 16(b) and a valid exercise of the SEC’s congressionally delegated authority.<sup>8</sup> The two courts of appeals that have considered this question reached the same conclusion. *Roth v. Perseus, L.L.C.*, 522 F.3d 242, 249 (2d Cir. 2008); *Dreiling v. Am. Express Co.*, 458 F.3d 942, 949-52 (9th Cir.2006).

As for new Rule 16b-7, the SEC explained in the 2005 adopting release that it is “based on the premise that the exempted transactions” – including reclassifications – “are of relatively minor importance to the shareholders of a particular company and do not present significant opportunities to insiders to profit by advance information concerning the transaction.” 2005 Amendments Release, 70 Fed.Reg. at 46,085. “Indeed,” the SEC continued, “by satisfying either of the rule’s 85% ownership tests, an exempted transaction does not significantly alter the economic investment held by the insider before the transaction.” *Id.* In essence, the SEC’s position is that reclassifications, in addition to mergers and consolidations, that meet the 85% cross-ownership require-

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<sup>8</sup> Levy maintains that the SEC’s reasoning is flawed because it “ignores [the fact] that such unfair short-term speculative activity can take place even absent a transaction with an uninformed member of the investing public.” (Appellant’s Br. 60 (emphasis added)). But Levy’s argument is based on a faulty premise, as a transaction “need not . . . pose absolutely no risk of speculative abuse” for the SEC to be free to exempt it from section 16(b) liability. *Dreiling v. Am. Express Co.*, 458 F.3d 942, 950 (9th Cir.2006). Rather, as indicated by the Supreme Court in its above explanation of section 16(b)’s purpose, the relevant inquiry is whether the risk of speculative abuse is not “intolerably great.” *Foremost-McKesson, Inc.*, 423 U.S. at 243, 96 S.Ct. 508 (quoting *Reliance Elec. Co.*, 404 U.S. at 422, 92 S.Ct. 596); accord *Dreiling*, 458 F.3d at 950.

ment do not pose much risk of abuse of inside information because they usually change merely the form of the insider's pre-existing investment in the issuer. *Id.* We think this is a reasonable explanation as to why the exempted transactions are not comprehended within the purpose of section 16(b) and, therefore, conclude that new Rule 16b-7, like new Rule 16b-3, is a permissible construction of section 16(b) and a valid exercise of the authority delegated to the SEC by Congress. We note that the only other court of appeals to have faced this issue as to Rule 16b-7 agreed, finding that new Rule "falls safely within the Commission's delegated authority." *Bruh v. Bessemer Venture Partners III L.P.*, 464 F.3d 202, 214 (2d Cir.2006).

### C.

Finally, Levy contends that, even if *Levy I* does not bind us for any of the reasons discussed above, and even if the new Rules are permissible constructions of section 16(b), actually applying the new Rules here to the 1999 reclassification would have an impermissible retroactive effect.

Drawing on the well-established principle that "[r]etroactivity is not favored in the law," the Supreme Court held in *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 208, 109 S.Ct. 468, 102 L.Ed.2d 493 (1988), that an agency may not promulgate rules that operate retroactively unless Congress has expressly delegated to it the authority to do so. However, we have held that a new rule should not be deemed to be "retroactive" in its operation – and thus does not implicate the Supreme Court's concerns in *Bowen* – if it "d[oes] not alter existing rights or obligations [but] merely clarifie[s] what those existing rights and obligations ha[ve] always been." *Appala-*

*chian States Low-Level Radioactive Waste Comm'n v. O'Leary*, 93 F.3d 103, 113 (3d Cir.1996). Thus, where a new rule constitutes a clarification – rather than a substantive change – of the law as it existed beforehand, the application of that new rule to pre-promulgation conduct necessarily does *not* have an impermissible retroactive effect, regardless of whether Congress has delegated retroactive rule-making power to the agency.

Many of our sister courts of appeals have endorsed similar approaches, finding retroactivity to be a non-issue with respect to new laws that clarify existing law. See, e.g., *Piamba Cortes v. Am. Airlines, Inc.*, 177 F.3d 1272, 1283 (11th Cir.1999) (“[C]oncerns about retroactive application are not implicated when an amendment that takes effect after the initiation of a lawsuit is deemed to clarify relevant law rather than effect a substantive change in the law.”); *Pope v. Shalala*, 998 F.2d 473, 483 (7th Cir.1993) (“A rule simply clarifying an unsettled or confusing area of the law . . . does not change the law, but restates what the law according to the agency is and has always been: ‘It is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand.’” (quoting *Manhattan Gen. Equip. Co. v. Comm’r*, 297 U.S. 129, 135, 56 S.Ct. 397, 80 L.Ed. 528 (1936))), *overruled on other grounds by Johnson v. Apfel*, 189 F.3d 561, 563 (7th Cir.1999); *Cookeville Reg’l Med. Ctr. v. Leavitt*, 531 F.3d 844, 849 (D.C.Cir.2008); *Brown v. Thompson*, 374 F.3d 253, 258-61 & n. 6 (4th Cir.2004); *ABKCO Music, Inc. v. LaVere*, 217 F.3d 684, 689-91 (9th Cir. 2000); *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir.1998); *Liquilux Gas Corp. v. Martin Gas Sales*, 979 F.2d

887, 890 (1st Cir.1992). *But see Princess Cruises, Inc. v. United States*, 397 F.3d 1358, 1363 (Fed.Cir.2005).

In determining whether a new regulation merely “clarifies” the existing law, “[t]here is no bright-line test” to guide us. *Marmolejos*, 140 F.3d at 491.<sup>9</sup> After reviewing the relevant case law from our Court and other courts of appeals, however, we think that four factors are particularly important for making this determination: (1) whether the text of the old regulation was ambiguous, *see, e.g., ABKCO Music, Inc.*, 217 F.3d at 691; *Piamba Cortes*, 177 F.3d at 1283-84; (2) whether the new regulation resolved, or at least attempted to resolve, that ambiguity, *see, e.g., Marmolejos*, 140 F.3d at 491; *Liquilux Gas Corp.*, 979 F.2d at 890; (3) whether the new regulation’s resolution of the ambiguity is consistent with the text of the old regulation, *see, e.g., Marmolejos*, 140 F.3d at 491; *Boddie v. Am. Broad. Cos.*, 881 F.2d 267, 269 (6th Cir.1989); and (4) whether the new regulation’s resolution of the ambiguity is consistent with the agency’s prior treatment of the issue, *see, e.g., First Nat’l Bank of Chi. v. Standard Bank &*

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<sup>9</sup> *Marmolejos* and a number of other Third Circuit cases that we discuss in this section involve amendments to the Sentencing Guidelines or its commentary made after the defendant had already been sentenced. Generally, a defendant’s sentence is to be based on the version of the advisory Guidelines and commentary in effect at the time of sentencing. U.S.S.G. § 1B1.11(a). However, unless an Ex Post Facto Clause violation would result, “a post-sentencing amendment . . . should be given effect” – and the defendant’s sentence adjusted accordingly – “if it ‘clarifies’ the guideline or comment in place at the time of sentencing.” *Marmolejos*, 140 F.3d at 490 (emphasis added). Because the ultimate inquiry is the same, we think our statements as to when an amendment to the Guidelines or its commentary is “clarifying” are equally applicable to the determination of whether an amendment to a statute or regulation is “clarifying.”

*Trust*, 172 F.3d 472, 479 (7th Cir.1999); *Orr*, 156 F.3d at 654.<sup>10</sup>

Before turning to the application of these four factors to the case before us, we note that there are two other factors on which some courts of appeals rely that we do not find to be all that significant. 'First, we do not consider an enacting body's description of an amendment as a "clarification" of the pre-amendment law to necessarily be relevant to the judicial analysis. *United States v. Diaz*, 245 F.3d 294, 304 (3d Cir. 2001); *Marmolejos*, 140 F.3d at 493. *But see Heimermann v. First Union Mortgage Corp.*, 305 F.3d 1257, 1260 (11th Cir.2002); *First Nat'l Bank*, 172 F.3d at 478. Second, we do not take the fact that an amendment conflicts with a judicial interpretation of the pre-amendment law to mean that the amendment is a substantive change and not just a clarification. *Marmolejos*, 140 F.3d at 492-93. As we explained in *Marmolejos*, "one could posit that quite the opposite was the case – that the new language was fashioned to clarify the ambiguity made apparent by

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<sup>10</sup> Levy devotes a number of pages in his briefs to the argument that the new Rules may not be applied to the 1999 reclassification because they are "legislative," as opposed to "interpretive." This distinction, however, does not advance his cause. The significance of a rule's classification as "legislative" is that an agency must promulgate it through the use of the formal notice-and-comment rulemaking procedures contained in the Administrative Procedure Act ("APA"). *Chao v. Rothermel*, 327 F.3d 223, 227 (3d Cir.2003). Although the inquiries may hinge on some of the same factors, the legislative-interpretive dichotomy has no bearing on whether a rule has an impermissible retroactive effect. Similarly, in response to another of Levy's contentions, we note that an agency's decision to use the APA's formal rulemaking procedures to promulgate a rule does not affect whether that rule may be applied to pre-promulgation conduct.



the caselaw.” *Id.* at 492.<sup>11</sup> *But see Nat’l Mining Ass’n v. Dep’t of Labor*, 292 F.3d 849, 860 (D.C.Cir.2002); *United States v. Capers*, 61 F.3d 1100, 1110 (4th Cir. 1995).

Focusing first on Rule 16b-3, we think that all four factors identified above point to the conclusion that the new Rule is a clarification of the previous version and that, thus, applying it to the 1999 reclassification would have no impermissible retroactive effect. First, we already determined in *Levy I* that old Rule 16b-3 (d)’s reference to “[a]ny transaction involving a grant, award or other acquisition from the issuer” was ambiguous. As discussed above, we thought it unclear from the text of the Rule whether “other acquisition” referred truly to *any* other acquisition or, instead, only to those acquisitions that, like grants and awards, involve compensation. *Levy I*, 314 F.3d at 121-22.<sup>12</sup> Second, new Rule 16b-3 resolved this

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<sup>11</sup> There are Guideline amendment cases in which we have made statements to the contrary, suggesting that a conflict with a prior judicial interpretation does make an amendment substantive, as opposed to clarifying. But these cases are distinguishable. In *United States v. Brennan*, 326 F.3d 176, 197-98 (3d Cir.2003), *Diaz*, 245 F.3d at 303, and *United States v. Bertoli*, 40 F.3d 1384, 1405-07 (3d Cir.1994), applying the new amendment would have resulted in a greater sentence for the defendant and thus would have implicated the Ex Post Facto Clause. As we explicitly indicated in *Marmolejos*, when ex post facto issues are involved, the rules of the game are different. 140 F.3d at 492 n. 6. In *United States v. Roberson*, 194 F.3d 408, 417-18 (3d Cir.1999), there was no pre-existing ambiguity in the Guidelines section at issue. The Sentencing Commission’s amendment to the commentary conflicted not only with a prior judicial construction, but also with the plain meaning, of the relevant provision. *Id.*

<sup>12</sup> *Levy* contends that “other acquisition” in the phrase “grant, award or other acquisition from the issuer” unambigu-



ambiguity, explicitly providing that the Rule's exemption is available "whether or not [the transaction at issue was] intended for a compensatory or other particular purpose." 17 C.F.R. § 240.16b-3(d). Third, the new Rule's resolution of the ambiguity is consistent with the text of the old Rule, which made no mention of a compensatory nexus requirement. Finally, the new Rule's resolution of the ambiguity is not at odds with the SEC's earlier-expressed understanding of the old Rule. To the contrary, as noted above, the SEC stated in the release it issued upon adopting the old Rule that "a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element." 1996 Rule 16b-3 Release, 61 Fed.Reg. at 30,379. Levy points to a number of SEC statements that suggest that, in promulgating old Rule 16b-3(d), the agency was primarily concerned with transactions pursuant to employee benefit plans; however, these statements do not conflict with the position that the old Rule

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ously referred only to transactions with a compensatory nexus because "grants" and "awards" both involve compensation. As support, he invokes the interpretive canon *ejusdem generis*, under which "where general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words." *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 114-15, 121 S.Ct. 1302, 149 L.Ed.2d 234 (2001) (internal quotation marks omitted). But while this may be one way to approach the language, it is not the only way. See *Chickasaw Nation v. United States*, 534 U.S. 84, 94, 122 S.Ct. 528, 151 L.Ed.2d 474 (2001) ("[C]anons [of interpretation] are not mandatory rules. They are guides that 'need not be conclusive.'" (quoting *Circuit City Stores, Inc.*, 532 U.S. at 115, 121 S.Ct. 1302)).

also applied to transactions with no compensatory nexus whatsoever.<sup>13</sup>

While the District Court chose to address the retroactivity implications of new Rule 16b-7 as well, we decline to do so. We have already determined that new Rule 16b-3(d) is a valid exercise of the SEC's authority, whose application to the 1999 reclassification would not give rise to any retroactivity concerns. Because this is a sufficient independent ground for affirming the District Court's disposition of the case, we express no opinion as to whether new Rule 16b-7 merely clarifies the old Rule or, relatedly, whether applying it here would have an impermissible retroactive effect.

#### IV.

In light of the foregoing, we will AFFIRM the District Court's grant of summary judgment to National and Sterling and its denial of summary judgment to Levy. Further, to the extent it is inconsistent with our opinion today, we OVERRULE *Levy I*.

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<sup>13</sup> Levy also maintains that by including subsection (f), which provided that certain "discretionary transactions" involving employee benefit plans required a six-month waiting period in order to be exempt, the SEC somehow implicitly conveyed the view that old Rule 16b-3(d) required a compensatory nexus. Specifically, he contends that it would have been irrational for the SEC not to exempt these discretionary transactions but to exempt purely volitional, non-compensation-related transactions, given that the latter arguably present greater opportunity for speculative abuse. Although Levy's argument may raise questions as to the wisdom of a particular regulatory scheme, we do not think that the SEC's inclusion of subsection (f) equated to a statement from the SEC that only transactions involving compensation fell within the scope of old Rule 16b-3(d).

UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF DELAWARE

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No. 00-994

MARK LEVY,  
*Plaintiff,*

v.

STERLING HOLDING COMPANY, LLC;  
NATIONAL SEMICONDUCTOR CORPORATION;  
FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,  
*Defendants.*

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Feb. 13, 2007

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SLEET, District Judge.

**I. INTRODUCTION**

On November 28, 2000, the plaintiff Mark Levy ("Levy") filed this shareholder's derivative suit on behalf of the defendant Fairchild Semiconductor ("Fairchild") after making an appropriate demand to the board. The complaint alleges that defendants National Semiconductor ("National") and Sterling Holding Company ("Sterling") (collectively, the "defendants"), who sit on the Fairchild Board of Directors, purchased Fairchild stocks and then sold those stocks at a profit within six months after purchase. Levy further alleges that National and Sterling's conduct violated the prohibition on short-swing profits due to insider trading expressed in section 16(b) of

the Securities and Exchange Act of 1934 (the "Act"). See 15 U.S.C. § 78p(b).

Presently before the court are Levy's, National's, and Sterling's cross-motions for summary judgment, pursuant to Federal Rule of Civil Procedure 56(c). For the reasons that follow, the court will grant National's and Sterling's motions for summary judgment and deny Levy's motion for summary judgment.

## **II. BACKGROUND**

### **A. Factual Background**

National and Sterling are both incorporated in the State of Delaware. On March 11, 1997, Fairchild was spun off from National pursuant to an Agreement and Plan of Recapitalization (the "Agreement"). The newly-created Fairchild issued three classes of stock to its original equity investors, i.e. National, certain members of Fairchild's management, and Sterling: (1) preferred stock, valued at \$1,000 per share with a cumulative dividend rate of 12%; (2) class A common stock, which had voting powers and was valued at \$0.50 per share; and (3) class B common stock, which did not have voting powers and was valued at \$0.50 per share. The class A common stock and class B common stock were freely convertible into each other at the election of the shareholder.

The Agreement permitted National and Sterling to retain or purchase stock in Fairchild. At that time, National retained 4,380,000 shares of class A common stock, 5,243,621 shares of class B common stock (after a four-for-one common stock split, which occurred in April 1998), and 11,667 shares of 12% series A cumulative compounding preferred stock. Sterling exercised its rights under the Agreement and purchased, for \$58.5 million, approximately

3,553,000 shares of class A common stock, 7,099,000 shares of class B common stock (again, after the April 1998 split), and 53,113 shares of the preferred stock.

In May 1999, Fairchild decided to go public through an initial public offering ("IPO"). When Fairchild interviewed potential underwriters, each of them took the position that Fairchild needed to eliminate its preferred stock in order to accomplish an IPO. In other words, Fairchild was informed that it should undergo a recapitalization in anticipation of its IPO. The recapitalization contemplated that preferred shares would be converted to common stock. Fairchild's certificate of incorporation, however, did not provide for the conversion of preferred stock into common stock. Accordingly, on July 1, 1999, a majority of Fairchild's common and preferred shareholders voted to convert all shares of preferred stock into class A common stock "automatically" upon completion of the IPO. The certificate of incorporation was amended to reflect the reclassification, and also set out a formula for the conversion of the shares.<sup>1</sup> According to the formula, each share of Fairchild's preferred stock was worth 75.714571 shares of class A common stock. As a result, Sterling acquired 4,021,428 shares and National acquired 888,362 shares of common stock in exchange for their preferred stock. These acquisitions occurred on

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<sup>1</sup> The conversion of preferred stock to common stock in the reclassification was accomplished by dividing the liquidation value of the preferred stock (i.e. \$1,000 per share plus accumulated unpaid dividends) by the price per share at which class A common stock would be offered to the public in the IPO, less the underwriting fees and commissions (i.e. \$17.39). The conversion resulted in a 75 to 1 ratio.

August 9, 1999, the date the IPO was completed. According to the prospectus filed by Fairchild on August 4, 1999, National was the beneficial owner of 14.8% of class A common stock and 14.9% of class B common stock. The prospectus also disclosed that, by 1999, Sterling was the beneficial owner of 48.0% of the class A common stock and 85.1% of the class B common stock.<sup>2</sup> Thus, both National and Sterling had stock ownership in Fairchild exceeding ten percent.

In late 1999, Fairchild planned a follow-on or secondary offering of its common stock. In accordance with Fairchild's plan, on January 19, 2000 (with a closing date of January 25, 2000), Sterling sold 11,115,000 shares of class A common stock and National sold 7,243,360 shares of class A common stock in the secondary offering for profits of \$58,511,777.00 and \$14,124,958.00, respectively. Both sales were within six months of the time National and Sterling acquired the new shares of common stock.

### **B. Procedural Background**

On November 28, 2000, Levy filed this shareholder's derivative suit against National and Sterling. On January 29, 2001, National and Sterling moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). On February 5, 2002, the court issued a Memorandum and Order granting the motion to dismiss and holding that Rule 16b-7 exempted the reclassification transaction at issue. (D.I. 46.) Levy appealed the court's decision to the Court of Appeals for the Third Circuit. On December 13, 2002, the Third Circuit issued an opinion

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<sup>2</sup> By 1999, Sterling's number of shares had grown to 14,212,000 shares of class A common stock and 28,396,000 shares of class B common stock.



in the matter, reversing this court's decision and holding, under its interpretation of Rule 16b-7, that it could not conclude at the motion to dismiss stage that Rule 16b-7 exempted the reclassification. See *Levy v. Sterling Holding Co.*, 314 F.3d 106, 125 (3d Cir.2002). The Third Circuit also held that, under its interpretation of Rule 16b-3(d), the exemption afforded could not apply to the reclassification at issue unless the transaction had some connection to a compensation-related function. *Id.* at 124.

National and Sterling subsequently petitioned the Third Circuit for rehearing or rehearing *en banc* on the issue. The Securities and Exchange Commission (the "SEC") joined the petition and filed an *amicus* brief, which urged the court to vacate its opinion. On April 30, 2003, the Third Circuit denied the petition for rehearing or rehearing *en banc*. National and Sterling filed a writ of certiorari with the Supreme Court, which the Court denied on October 14, 2003. See *Sterling Holding Co. v. Levy*, 540 U.S. 947, 124 S.Ct. 389, 157 L.Ed.2d 277 (2003).

On June 4, 2004, the parties filed the cross-motions for summary judgment that are presently at issue. On June 21, 2004, the SEC disseminated a release titled *Proposed Rule: Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release Nos. 34-49895; 35-27861; IC-26471, 69 Fed.Reg. 35,982 (the "Proposed Amendments") in an effort to amend Rules 16b-3(d) and 16b-7. On June 25, 2004, National and Sterling filed a motion to stay the proceedings pending final action by the SEC on the Proposed Amendments to SEC Rules 16b-3 and 16b-7. The court issued an Order (D.I. 223) on September 27, 2004, granting the motion and staying the proceedings. On August 3, 2005, the SEC

adopted the Proposed Amendments. See *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 34-52202, 70 Fed.Reg. 46,080 (Aug. 9, 2005) (the "Amendments").

On August 11, 2005, the court issued an Order (D.I. 236) lifting the stay and directing the parties to file briefing with respect to two issues: (1) whether the Amendments are entitled to deference; and (2) whether the court should apply the Amendments retroactively to the reclassification at issue in the context of resolving the parties' competing summary judgment motions. The court heard oral argument regarding the two issues on November 1, 2005 and took the matter under advisement.

### III. STANDARD OF REVIEW

A grant of summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c); *Biener v. Calio*, 361 F.3d 206 (3d Cir.2004). In reviewing summary judgment decisions, the Third Circuit views all evidence and draws all inferences in the light most favorable to the non-movant, affirming if no reasonable jury could find for the non-movant. See *Whiteland Woods, L.P. v. Twp. of West Whiteland*, 193 F.3d 177, 180 (3d Cir.1999). Thus, a trial court should only grant summary judgment if it determines that no "reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

If a moving party has demonstrated the absence of a genuine issue of material fact – meaning that no reasonable jury could find in the nonmoving party's favor based on the record as a whole – concerns regarding the credibility of witnesses cannot defeat summary judgment. Instead, the nonmoving party must “present affirmative evidence in order to defeat a properly supported motion for summary judgment.” *Liberty Lobby*, 477 U.S. at 256-57, 106 S.Ct. 2505 (citation omitted). Thus, summary judgment is particularly appropriate where, notwithstanding issues of credibility, the nonmoving party has presented no evidence or inferences that would allow a reasonable mind to rule in its favor. In this situation, it may be said that the record as a whole points in one direction and the dispute is not “genuine.” *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 586, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986).

#### IV. DISCUSSION

Before the court can consider the parties' cross-motions for summary judgment, it must determine whether it owes deference to the SEC's interpretation of Rules 16b-3 and 16b-7. Additionally, the court must determine whether the Amendments apply to the reclassification at issue in the present case.

##### A. Whether the Amendments are Permissible Readings of Section 16(b)

The SEC amended Rules 16b-3 and 16b-7 in 2005 to “resolve any doubt as to the meaning and interpretation of these rules [16b-3 and 16b-7] by reaffirming the views [it has] consistently expressed previously regarding their appropriate construction.” 70 Fed. Reg. 46,080, 46,080 (Aug. 9, 2005). Specifically, with respect to Rule 16b-3(d), the SEC noted that the amendment was necessary “to eliminate the un-

certainty generated by the *Levy v. Sterling* opinion," and to reassure insiders and issuers that non-compensatory acquisitions are included within the scope of Rule 16b-3's exemption.<sup>3</sup> *Id.* at 46,082; see *id.* at 46,083 (exempting "any transaction . . . involving an acquisition by an officer or director from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose"). Further, the SEC con-

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<sup>3</sup> Prior to the Amendments, Rule 16b-3(d) stated:

17 C.F.R. § 240.16b-3 Transactions between an issuer and its officers or directors.

....

(d) Grants, awards and other acquisitions from the issuer. Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; provided that such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

cluded that, because Rule 16b-3(d) “clarif[ies] regulatory conditions that applied to the[] exemptions since they became effective on August 15, 1996, [it is] available to any transaction on or after August 15, 1996 that satisfies the regulatory conditions so clarified.” *Id.* at 46,080.

With respect to Rule 16b-7, the SEC stated that the *Levy* opinion “imposed upon reclassifications exemptive conditions that are not found in the language of [the rule,] and would not apply to a merger or consolidation relying upon the rule.” 70 Fed.Reg. 46,080, 46,084. Thus, the SEC proposed to amend Rule 16b-7 “to eliminate uncertainty generated by the *Levy v. Sterling* opinion,” and to specify that that the rule applies to reclassifications on the same basis as mergers and consolidations.<sup>4</sup> *Id.* at 46,084-85. In

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<sup>4</sup> Prior to the Amendments, Rule 16b-7 stated:

17 C.F.R. § 240.16b-7 Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either (i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or (ii) The combined assets of all the companies involved in the merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger or consolidation, of a company which, prior to the merger or consolidation, owned 85 percent or more of either (i) The



addition, the SEC concluded that, because Rule 16b-7 "clarifies regulatory conditions that applied to th[e] exemption since it was amended effective May 1, 1991, it is available to any transaction on or after May 1, 1991 that satisfies the regulatory conditions so clarified." *Id.* at 46,080.

Here, the defendants contend that because the Amendments do not change the law but, rather, clarify what it was before, they apply to the reclassification at issue in this case. (D.I. 242, at 5.) To support their proposition, the defendants cite a number of cases, as well as the SEC's own language in the Amendments' adopting release, which refers to them as "clarify[ing]," and explains that they apply to any transaction occurring on or after the dates that the pre-amendment versions of the rules were adopted.

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equity securities of all other companies involved in the merger or consolidation or, in the case of a consolidation, the resulting company; or (ii) The combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger or consolidation and any non-exempt sale of a security in any company involved in the merger or consolidation within any period of less than six months during which the merger or consolidation took place, the exemption provided by this Rule shall be unavailable to the extent of such purchase and sale.



(See *Id.* at 7-9.) Conversely, Levy contends that “the [SEC’s] views as to whether its rules are legislative or interpretive are not entitled to deference” and, regardless of how labeled, the Amendments cannot be applied retroactively. (D.I. 239, at 4, 9.) Here, if the defendants are correct, and the Amendments apply to any transaction occurring after the Rules’ effective dates, then the transactions at issue are exempt from section 16(b). The court, therefore, must determine whether the Amendments “establish[] an interpretation that ‘changes the legal landscape.’” *Nat’l Mining Ass’n v. Dep’t of Labor*, 292 F.3d 849, 859 (D.C.Cir.2002) (citing cases); *see also Princess Cruises, Inc. v. United States*, 397 F.3d 1358, 1363 (Fed.Cir.2005). However, prior to making that determination, the court must consider whether Congress has authorized the SEC to exempt the insider short-swing transactions at issue from section 16(b) liability and, if so, whether the SEC’s interpretation of its own rules is a permissible reading of section 16(b).

Section 16(b) of the Act imposes liability for “short-swing” profits – that is – it forbids an insider’s speculative short-term trading based upon insider information. “Its purpose is to prevent corporate insiders from exploiting material information about the issuer to have an advantage over others with whom they trade.” *Bruh v. Bessemer Venture Partners III L.P.*, No. 03 Civ. 7340(GBD), 2005 WL 2087803, at \* 3 (S.D.N.Y. Aug. 29, 2005) (citing *Gwozdzensky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998)). Section 16(b) provides, in pertinent part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by rea-

son of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of the issuer . . . within a period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction . . . . *This subsection shall not be construed to cover . . . any transaction or transactions which the [SEC] by rules and regulations may exempt as not comprehended within the purpose of this subsection.*

15 U.S.C. § 78p(b) (2004) (emphasis added). Accordingly, the text of section 16(b) demonstrates that Congress gave the SEC broad authority, which includes the authority to promulgate binding legal rules to exempt certain insider transactions from section 16(b)'s reach. In view of this broad authority, the court will apply the analysis set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984) to the SEC's interpretation of its rules exempting transactions from section 16(b).

In *Chevron*, the Supreme Court espoused a two-step framework for courts to follow when reviewing an agency's actions. The court must first determine "whether Congress has directly spoken to the precise question at issue." *Appalachian States Low-Level Radioactive Waste Commission v. O'Leary*, 93 F.3d 103, 108 (3d Cir.1996) (citing *Chevron*, 467 U.S. at 842-43, 104 S.Ct. 2778). If the court's answer is "no," meaning that Congress has not directly spoken to the issue, then "the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Appalachian States*, 93 F.3d at

108 (citation omitted). If the court finds that it is, it must give deference to that interpretation. “If Congress ‘explicitly left a gap for an agency to fill . . . a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.’”<sup>5</sup> *Robert Wood Johnson Univ. Hosp. v. Thompson*, 297 F.3d 273, 281 (3d Cir.2002).

Moreover, “[a] court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference *only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.*” *Nat’l Cable & Telecomm. Assoc. v. Brand X Internet Servs.*, 545 U.S. 967, 982, 125 S.Ct. 2688, 162 L.Ed.2d 820 (2005) (emphasis added). This is because “*Chevron* established a ‘presumption that Congress, when it left ambiguity in a statute meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the courts) to possess whatever degree of discretion the ambiguity allows.’” *Id.* (citing *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 740-41, 116 S.Ct. 1730, 135 L.Ed.2d 25 (1996)). Therefore, “[o]nly a judicial precedent holding that the statute unambiguously forecloses the agency’s interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.” *Brand X*, 545 U.S. at 982-83, 125 S.Ct. 2688.

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<sup>5</sup> *Chevron* analysis also applies to an agency interpretation contained in a regulation. *Christensen v. Harris County*, 529 U.S. 576, 587, 120 S.Ct. 1655, 146 L.Ed.2d 621 (2000).

Here, as previously mentioned, Congress explicitly afforded the SEC the authority to exempt transactions from the reach of section 16(b). Therefore, section 16(b) does not unambiguously foreclose the SEC's interpretation but, rather, requires the SEC to interpret which transactions are exempt from its application. See *Levy*, 314 F.3d at 112 ("As we have indicated, section 16(b) explicitly authorizes the SEC to exempt 'any transaction . . . as not comprehended within the purpose of the statute. This section is critical, for courts defer to an agency's interpretation of statutes, particularly where the statute provides the agency with authority to make the interpretation.") In other words, Congress did not speak to the precise question at issue, but explicitly left a gap for the SEC to fill. The SEC filled this gap by promulgating rules exempting certain transactions. As the Third Circuit noted in *Levy*, however, "the SEC [rules did] not set forth [the SEC's] interpretation [of section 16(b)] clearly." *Id.* Thus, the court endeavored to determine the proper interpretation of those rules. Noteworthy, however, is the fact that the Third Circuit did not hold that its interpretation of the SEC Rules was derived from the unambiguous language of either section 16(b) or Rules 16b-3 and 16b-7.<sup>6</sup> In

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<sup>6</sup> *Levy* seems to suggest otherwise, arguing that the Amendments cannot overrule the Third Circuit's "mandate" in *Levy*. (D.I. 247, at 10-11.) What *Levy* fails to appreciate, however, is the Third Circuit's guidance with respect to issues of interpretation, set forth in *United States v. Marmolejos*, for example, in which Judge Rendell stated "[w]here a prior panel of this court has interpreted an ambiguous statute in one way, and the responsible administrative agency later resolves the ambiguity another way, this court is not bound to close its eyes to the new source of enlightenment." 140 F.3d 488, 493 (3d Cir.1998). Consequently, *Levy's* arguments to the contrary with respect

response to the Third Circuit's criticism of its lack of clarity in the interpretation of section 16(b), the SEC released the Amendments to "resolve any doubt as to the meaning and interpretation of these rules [Rules 16b-3 and 16b-7]." 70 Fed.Reg. 46,080, 46,081. Accordingly, because the Third Circuit did not conclude that section 16(b) unambiguously foreclosed the SEC's interpretation as set forth in the Amendments, its ruling in the *Levy* case does not displace that interpretation. The court, therefore, must apply the second prong of the *Chevron* analysis to determine whether the Amendments are based on a permissible construction of section 16(b).

Here, the legislative history and purpose of the statute support the SEC's interpretations set forth in the Amendments. The clear aim of the section was "the general evil of officers and directors rigging their stock up and down squeezing out their own stockholders." Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-18114, 46 Fed.Reg. 48,147 (Sept. 24, 1981) (quoting Stock Exchange Practices, Report of the Committee on Banking and Currency, S.Rep. No. 1455, 73rd Cong., 1st Sess., pt. 15, at 6559 (1934)). In *Levy*, the Third Circuit noted that the Supreme Court has also explained the purpose of section 16(b):

The general purpose of Congress in enacting s[ection] 16(b) is well known . . . . Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, these persons could reap profits

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to deference to administrative agency interpretations are misguided.



at the expense of less well informed investors. In s[ection] 16(b) Congress sought to 'curb the evils of insider trading (by) . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.' . . . It accomplished this by defining directors, officers, and beneficial owners as those presumed to have access to inside information and enacting a flat rule that a corporation could recover the profits these insiders made on a pair of security transactions within six months.

314 F.3d at 110 (quoting *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243-44, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976)).<sup>7</sup> Based on the Senate Committee's observations and the Supreme Court's explanation, the court finds that the central purpose behind section 16(b) was to curb insider trading, which "is rooted in inequality of information between persons who are aware of it and the persons they

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<sup>7</sup> Further, the Senate Committee that considered the bill which became section 16(b) observed the following:

{a}mong the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their *market activities*. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.

Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-18114, 46 Fed.Reg. 48,147 (Sept. 24, 1981) (quoting Stock Exchange Practices, Report of the Committee on Banking and Currency, S.Rep. No. 1455, 73rd Cong., 2d Sess., at 55 (1934)) (emphasis added).



transact with.” 70 Fed.Reg. 46,080, 46083. Stated another way, the unfair use of information that Congress desired section 16(b) to remedy was the use of information known by officers and directors, but not by investors, to the disadvantage of uninformed investors.

As the SEC explains in both the adopting release to the 1996 amendment to Rule 16b-3 and the current Amendments, the inequality of information that section 16(b) was designed to remedy “generally does not exist when an officer or director acquires securities from, or disposes of them to, the issuer.” 70 Fed.Reg. 46,080, 46,083; *see* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-37260, 61 Fed.Reg. 30,376, 30,377 (June 14, 1996). Indeed, the 1996 amendment focused on the distinction between issuer and officer/director transactions, and market transactions by officers and directors, explaining that “where the issuer, rather than the trading markets, is on the other side of an officer or director’s transaction in the issuer’s equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute.” 61 Fed.Reg. 30,376, 30,377. The SEC then concluded that its experience with section 16 “persuaded [it] that transactions between the issuer and its officers and directors that are pursuant to plans . . . that satisfy . . . objective gate-keeping conditions are not vehicles for the speculative abuse that section 16(b) was designed to prevent,” and exempted those transactions under Rule 16b-3. *Id.* After exempting transactions between an issuer and its officers and directors, the SEC explained that transactions with issuer-

sponsored employee benefit plans would be treated as issuer to officer/director transactions and, further, that they "need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need [they] specifically have a compensatory element." *Id.* at 30,378-79. The SEC made these revisions to Rule 16b-3 in 1996, in order "to align better the regulatory requirements under the rule with the statutory goals underlying section 16," and intended them, in part, "to streamline the section 16 regulatory scheme, particularly with respect to transactions between an issuer and its officers and directors . . . [and] broaden exemptions from short-swing profit recovery where consistent with the statutory purpose." 61 Fed.Reg. 30,376, 30,376, 30,380.

The Amendment to Rule 16b-3 reiterates the purpose behind and legislative contemplation that went into section 16(b). 70 Fed.Reg. 46,080, 46,081-82. More important, however, is the fact that the Amendment reaffirms the SEC's earlier conclusion that transactions between an issuer and its officers and directors are not the type of "insider" transactions contemplated by section 16(b), and need not have a compensatory element to qualify for exemption under Rule 16b-3(d). *Id.* at 46,083.

The SEC also has interpreted that reclassifications fall outside the evils that section 16(b) was designed to protect against. In 1981, the SEC issued a release in which it interpreted its rules under section 16(b). See Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed.Reg. 48,147 (Oct. 1, 1981). The SEC issued the interpretive release because it had been receiving a number of similar questions regarding the provisions of the rules prom-

ulgated under section 16. *See id.* at 48,147. In the release, the SEC states that the exemption under Rule 16b-7 “is based on the premise that [the exempted] transactions are of relatively minor importance to the stockholders of a particular company and do not present significant opportunities to insiders to profit by advance information . . . .” *Id.* at 48,176. One of the questions that the SEC addressed in the release was whether Rule 16b-7 applied to reclassifications, even though they weren’t specifically mentioned in the text of the rule. *Id.* at 48,176-77 (Question 142). It concluded that, because Rule 16b-7 “does not require that the security received in exchange be similar to that surrendered,” it “can apply to transactions involving reclassifications.” *Id.* at 48,177.

In 1991, the SEC made revisions to Rule 16b-7, adding the word “reclassifications” to the title of the rule, but explaining that the amendment was not intended to make any substantive change. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-28869, 56 Fed.Reg. 7242, 7262-63, 7273 (Feb. 21, 1991). In 2002, the SEC expressly stated that corporate reclassifications were exempt from 16(b) liability under Rule 16b-7. *See* Form 8-k Disclosure of Certain Management Transactions, Release Nos. 33-8090, 34-45742, 67 Fed.Reg. 19,914, 11,919 n. 56 (“These [acquisitions or dispositions pursuant to holding company formations and similar corporate reclassifications and consolidations] are the transactions exempted from section 16(b) short-swing profit recovery by Exchange Act Rule 16b-7.”).

The current Amendment to Rule 16b-7 reaffirms the SEC’s prior position on reclassifications, as voiced

in the 1981, 1991, and 2002 releases. The Amendment also notes that, similar to a merger exempted by the rule, a reclassification "effects no major change in the issuer's business or assets." 70 Fed. Reg. 46,080, 46,084 (illustrating that reclassifications are similar to mergers exempted by Rule 16b-7, in that an issuer "could effect a reclassification by forming a wholly-owned 'shell' subsidiary, merging the issuer into the subsidiary, and exchanging securities for the issuer's securities"). Finally, the Amendment reaffirms that reclassifications, "which do not involve a substantial change in the business owned, do not involve the holders' payment of consideration in addition to the reclassified class or series of securities, and have the same effect on all holders of the reclassified class or series, do not present insiders the significant opportunities to profit by advance information that [s]ection 16(b) was designed to address." 70 Fed. Reg. 46,080, 46,085.

Given the foregoing analysis, the court finds that the Amendments are permissible readings of the statute and further concludes that they "bear[] a fair relationship to the language of the statute, reflect[] the views of those who sought its enactment, and match[] the purpose they articulated." *Appalachian States*, 93 F.3d at 110. As such, this court may not substitute its judgment for the SEC's judgment. Therefore, the only issues remaining for the court to determine are whether the amended or pre-amendment Rules 16b-3 and 16b-7 apply to the transactions at issue in the present case, which occurred in 1999 and 2000, and whether any party is entitled to summary judgment.

## B. Retroactivity

Levy contends that even if the court labels the Amendments interpretive rules, applying them to the case at bar is impermissible under the retroactivity doctrine. (See D.I. 247, at 10.) "Retroactivity is not favored in the law." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208, 109 S.Ct. 468, 102 L.Ed.2d 493 (1988). Thus, "congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result." *Id.* However, not every change in an administrative rule effects such a change that it will be considered as operating retroactively. The Supreme Court has stated in *Landgraf v. USI Film Products* that:

[a] statute [or rule] does not operate "retrospectively" merely because it is applied in a case arising from conduct antedating the statute's [or rule's] enactment . . . or upsets expectations based in prior law. Rather, the court must ask whether the new provision attaches new legal consequences to events completed before its enactment. The conclusion that a particular rule operates "retroactively" comes at the end of a process of judgment concerning the nature and extent of the change in the law and the degree of connection between the operation of the new rule and a relevant past event.

511 U.S. 244, 269-70, 114 S.Ct. 1483, 128 L.Ed.2d 229 (1994) (internal citations and footnote omitted). Following this pronounced standard, the court must determine whether the Amendments "take[] away or impair[] vested rights acquired under the existing laws, or create[] a new obligation, impose[] a new duty, or attach[] a new disability, in respect to trans-

actions or considerations already past.” *Princess Cruises, Inc. v. United States*, 397 F.3d 1358, 1362 (Fed.Cir.2005). Put another way, the court must consider more than the mere fact that a change or amendment has occurred – it must also consider “the nature and extent of the change in the law.” *Id.* at 1363 (citing *Landgraf*, 511 U.S. at 270, 114 S.Ct. 1483). “The strongest indication of a substantive change is inconsistency with a previously stated position.” *First Nat’l Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 479 (7th Cir.1999).

The Amendment to Rule 16b-3(d) is now titled “Acquisitions from the issuer,” and adds the words “whether or not intended for a compensatory or other particular purpose.”<sup>8</sup> 17 C.F.R. § 240.16b-3 (2005).

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<sup>8</sup> The current version of Rule 16b-3(d) reads as follows, with the new language underlined:

17 C.F.R. § 240.16b-3 Transactions between an issuer and its officers or directors.

....

(d) *Acquisitions from the issuer.* Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (*including without limitation a grant or award*), *whether or not intended for a compensatory or other particular purpose*, shall be exempt if:

- (1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;
- (2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; provided that



The Amendment to Rule 16b-7 adds the word "reclassification" to the terms merger or consolidation that appear in the pre-amendment version of the rule. 17 C.F.R. 240.16b-7 (2005). It also adds the phrase "[t]he exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions."<sup>9</sup> 17 C.F.R. 240.16b-7. As previously

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such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

<sup>9</sup> The current version of Rule 16b-7 reads as follows, with the new language underlined:

17 C.F.R. § 240.16b-7 Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger, *reclassification*, or consolidation, in exchange for a security of a company *that before* the merger, *reclassification*, or consolidation, owned 85 percent or more of either: (i) The equity securities of all other companies involved in the merger, *reclassification*, or consolidation, or in the case of a consolidation, the resulting company; or (ii) The combined assets of all the companies involved in the merger, *reclassification*, or consolidation, computed according to their book values *before* the merger, *reclassification*, or consolidation as determined by reference to their most recent available financial statements for a 12 month period

noted, the SEC made these revisions to remove any doubt as to the nature and scope of transactions exempted from section 16(b) short-swing profit recovery by Rules 16b-3 and 16b-7. 70 Fed.Reg. 46,080, 46,081. Levy argues that even though the SEC

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*before the merger, reclassification, or consolidation, or such shorter time as the company has been in existence.*

(2) The disposition of a security, pursuant to a merger, *reclassification*, or consolidation, of a company *that before the merger, reclassification, or consolidation, owned 85 percent or more of either (i) The equity securities of all other companies involved in the merger, reclassification, or consolidation or, in the case of a consolidation, the resulting company; or (ii) The combined assets of all the companies undergoing merger, reclassification, or consolidation, computed according to their book values before the merger, reclassification, or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification, or consolidation.*

(b) a merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) *The exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions.*

(d) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger, *reclassification*, or consolidation and any non-exempt sale of a security in any company involved in the merger, *reclassification*, or consolidation within any period of less than six months during which the merger, *reclassification*, or consolidation took place, the exemption provided by this section shall be unavailable to the extent of such purchase and sale.

refers to the Amendments as clarifying, they are not clarifying but, instead, legislative rules effecting substantive changes in the law. (D.I. 239, at 4-5.) An examination of the SEC's previously stated position, however, reveals that it is consistent with the Amendments. In other words, the Amendments do not change the legal landscape with respect to exemptions under section 16(b). The SEC's position appears in the previously-discussed adopting releases to Rules 16b-3 and 16b-7, as well as several persuasive no-action letters authored by SEC staff, which the court now addresses.

On January 12, 1999, the SEC issued a No-Action Letter to Skadden, Arps, Slate, Meagher & Flom LLP (the "Skadden Letter") regarding the application of Rule 16b-3 to transactions occurring in the context of corporate mergers. See Skadden, Arps, Meagher & Flom LLP, SEC No-Action Letter, 1999 WL 11540 (Jan. 12, 1999). In this letter, the SEC interpreted Rule 16b-3(d) to exempt "the acquisition of acquiror equity securities (including acquiror derivative securities) by officers and directors of the acquiror through the conversion of target equity securities in connection with a merger." *Id.* at \*1. The transaction described in the letter is a transaction outside of the compensatory context, and one that the SEC concluded would be exempt under Rule 16b-3(d). Accordingly, the Skadden Letter provides persuasive support for the defendants' position that the Amendments effected no change in the application of Rule 16b-3.<sup>10</sup>

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<sup>10</sup> The court is also persuaded by the opinion in *Gryl v. Shire Pharmaceuticals Group PLC*, in which the United States Court of Appeals for the Second Circuit held that Rule 16b-3(d) exempted acquiror directors' acquisitions and sales of acquiror

Similarly, the SEC's No-Action Letters to Monk-Austin, Inc. ("Monk-Austin") and St. Charles Acquisition Limited Partnership ("St.Charles") demonstrate that the SEC had interpreted Rule 16b-7 to apply to reclassifications. See *Monk-Austin, Inc.*, No-Action Letter, 1992 WL 337451 (Nov. 19, 1992); *St. Charles Acquisition Ltd. P'ship*, No-Action Letter, 1992 WL 146565 (June 25, 1992). In the Monk-Austin letter, the company seeking the SEC's advice planned to effect a recapitalization in which a new class of common stock would be created, and all outstanding shares of capital stock would be converted into shares of common stock. *Monk-Austin*, 1992 WL 337451, at \*1. Monk-Austin asked the SEC to concur in its view that the receipt of common stock in the recapitalization would be exempt under Rule 16b-7. *Id.* at \*2. Monk-Austin set forth its understanding of the types of transactions that Rule 16b-7 exempts:

The Staff has long recognized that Rule 16b-7, which exempts mergers and other transactions in which securities received in the transaction are issued by a company that owned 85% of all other companies involved in the transaction, is designed to exempt transactions that are subject to little abuse by insiders and "do not significantly alter in an economic sense the type of security which the insider held prior to the transaction." In the [September 23,] 1981[SEC] Re-

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options upon conversion of their target options in a corporate merger. See 298 F.3d 136, 145-46 (2d Cir.2002) ("So long as the relevant securities transaction is between an issuer and insider, and so long as the terms and conditions of that transaction receive advance approval by the board of directors, there exists sufficient protection to ensure that any short-swing profit taking that follows is not the result of unfair market manipulation.").

lease, the Staff took the position that Rule 16b-7 could apply to transactions structured as reclassifications if all other conditions of the rule were satisfied.

*Id.* at \*3 (citations omitted). Monk-Austin then posited that “[t]he acquisition by the Company’s shareholders of shares of Common Stock should be exempt from Section 16(b) by virtue of Rule 16b-7,” because “the recapitalization is effected to change the capital structure in preparation for an IPO and not to change the economic or other nature of their investment in the Company.” *Id.* The SEC determined that the Monk-Austin transaction would be exempt under Rule 16b-7. In *St. Charles*, the partnership involved sought guidance regarding Rule 16b-7 exemptions. *St. Charles*, 1992 WL 146565, at \*1. After analyzing the facts presented, the SEC concluded that the partnership’s restructuring would be exempt under Rule 16b-7, because the proportionate interest of the shareholders was unchanged by the transaction. *Id.* at \*4 (noting that the proposed restructuring is “within the spirit and intent of Rule 16b-7”). The foregoing analysis, as well as the courts discussion of the Rule 16b-3 and Rule 16b-7 adopting releases, demonstrate that the Amendments are consistent with the SEC’s previously-stated positions regarding these rules. As such, the court concludes that the Amendments are not substantive changes in the law.

Levy also argues that the Amendments effect substantive changes in the law because they “rewrit[e]” Rules 16b-3(d) and 16b-7. (D.I. 239, at 6.) The court is not persuaded. A change in the text of a regulation does not necessarily denote a substantive change. See *United States v. Marmolejos*, 140 F.3d 488, 492 (3d Cir.1998); *Homemakers North Shore, Inc. v.*



*Bowen*, 832 F.2d 408, 413 (7th Cir.1987) (noting that “[n]ew language need not imply new substance”). Moreover, the court believes that focusing its analysis on the fact that the text of the rule has changed would be a mistake. Instead, the proper focus should be on the effect of the change in the text of the rule. In the present case, as previously noted, the Third Circuit in *Levy* found the SEC’s interpretations of the pre-amendment versions of Rules 16b-3 and 16b-7 less than clear. See *Levy*, 314 F.3d at 112 (“the SEC has not set forth its interpretation [of section 16(b)] clearly”); *id.* at 114 (“In the absence of specific SEC guidance about which reclassifications are exempt from section 16(b) under Rule 16b-7, we believe that two principles should guide us.”). The SEC, therefore, undertook to remove any doubt as to the meaning of those rules by amending them, but did not change its prior interpretation of the rules. Accordingly, as the court has already concluded above, the legal effect of the amended rules is the same as the legal effect of the pre-amendment rules. That is, despite the differences between the text of the Amendments rules and the pre-amendment rules, the SEC has consistently provided only one position with respect to Rules 16b-3 and 16b-7. See *First Nat’l Bank*, 172 F.3d at 479.<sup>11</sup>

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<sup>11</sup> *Levy* advances a number of other arguments as to why the Amendments effect substantive changes in the law, including: (1) the length of time that elapsed from the initial adoptions of the Rules and the Amendments (D.I. 239, at 6 or 7 op br); (2) the length of time that elapsed from the publishing of the Amendments to their adoption (*Id.* at 7); (3) the fact that the Amendments were adopted by a notice and comment period (*Id.* at 6-7); and (4) the fact that the SEC invoked its legislative authority in proposing the Amendments (*Id.* at 8). These arguments may be an attempt to divert the court from the real task at hand, which is determining, as it has, whether the Amend-



Therefore, the court concludes that the Amendments are clarifying amendments available to any transaction on or after August 15, 1996 and May 1, 1991, for rules 16b-3 and 16b-7, respectively.

### **C. Summary Judgment**

Levy, National, and Sterling have filed cross-motions for summary judgment in this case. National and Sterling contend in their respective motions that, when shares are acquired as the result of a reclassification, the transaction cannot be considered a purchase for section 16(b) purposes, because it is exempt under Rule 16b-7. Additionally, Sterling argues that the reclassification is exempt under Rule 16b-3(d). Conversely, Levy argues that neither exemption to section 16(b) applies to the transactions at issue in the present case. Levy, however, has acknowledged that the defendants would be entitled to summary judgment if the Third Circuit had adopted the SEC's interpretation of Rules 16b-3 and 16b-7. (D.I. 143, at 5 ("It is no secret that if the Third Circuit had adopted the SEC's position that this litigation would have been over – Defendants would have won as a matter of law and there would have been no need for additional proceedings beyond affirming the District Court's original decision.")); See Tr. at 5:11-22 (standing by position that the defendants would have won if the SEC position was adopted by the Third Circuit).

The elements of a claim under section 16(b) are that "there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any

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ments change the nature and extent of the law. Thus, the court will not consider them in its analysis.

one class of the issuer's securities (4) within a six-month period." *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir.1998). The only element that the parties dispute here is whether the reclassification transactions upon the conversion of the preferred stock into common stock were non-exempt purchases under section 16(b) of the Act. Having already determined that it should defer to the SEC's interpretations of Rules 16b-3(d) and 16b-7 in the Amendments, which provide that the reclassification transactions at issue are exempt because they are not within the purview of section 16(b), the court concludes that no genuine issue of material fact exists in the present case. Accordingly, the defendants are entitled to judgment as a matter of law.<sup>12</sup>

## V. CONCLUSION

For the aforementioned reasons, the defendants' motion will be granted and the plaintiff's motion will be denied.

## ORDER

For the reasons stated in the court's Memorandum Opinion of this same date, IT IS HEREBY ORDERED that:

1. The plaintiff's Motion for Summary Judgment (D.I. 119) is DENIED.
2. The defendant National's Motion for Summary Judgment (D.I. 122) is GRANTED.
3. The defendant Sterling's Motion for Summary Judgment (D.I. 125) is GRANTED.

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<sup>12</sup> Because the court has determined that the defendants are entitled to summary judgment based on Rules 16b-3(d) and 16b-7, it need not consider their alternative legal theories for summary judgment.

4. Judgment is hereby entered in favor of the defendants, National and Sterling.
5. The Clerk of Court is directed to close this case.

UNITED STATES COURT OF APPEALS  
FOR THE THIRD CIRCUIT

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No. 02-1698

MARK LEVY,  
*Appellant,*  
v.

STERLING HOLDING COMPANY, LLC;  
NATIONAL SEMICONDUCTOR CORPORATION;  
FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,  
*Appellees.*

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Argued Oct. 29, 2002

Filed: Dec. 19, 2002

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BEFORE: NYGAARD, GREENBERG, and MICHEL,  
Circuit Judges.

**OPINION OF THE COURT**

GREENBERG, Circuit Judge.

**I. INTRODUCTION**

This matter comes on before this court on an appeal from an order granting a motion to dismiss for failure to state a claim on which relief may be granted entered in the district court on February 5, 2002. Plaintiff-appellant, Mark Levy, a shareholder in Fairchild Semiconductor International, Inc. ("Fair-

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\* Honorable Paul R. Michel, Judge for the United States Court of Appeals for the Federal Circuit, sitting by designation.

child”), a nominal defendant-appellee not participating in this appeal, brought this shareholder derivative action on November 28, 2000, against defendants-appellees Sterling Holding Co. (“Sterling”) and National Semiconductor Corp. (“National”) after Fairchild declined to initiate a lawsuit seeking relief for the matters of which Levy complains. Levy by this action seeks a judgment requiring Sterling and National to disgorge what he alleges were “short-swing insider trading profits of more than \$72 million” in Fairchild stock. Levy predicates the action on section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), which deprives specified insiders from profiting from certain offsetting purchase and sale securities transactions completed within less than a six-month period. The district court had jurisdiction under section 27 of the Exchange Act, 15 U.S.C. § 78aa, and we have jurisdiction under 28 U.S.C. § 1291. We exercise plenary review on this appeal. *See Gallo v. City of Philadelphia*, 161 F.3d 217, 221 (3d Cir.1998).

## II. HISTORY

In view of the procedural posture of the case we take the facts from Levy's allegations. On March 11, 1997, National spun off Fairchild pursuant to an Agreement and Plan of Recapitalization. At that time National retained in Fairchild 4,380,000 shares of Class A common stock, 5,243,621 shares of Class B common stock (as measured after a four-for-one common stock split on April 29, 1998), and 11,667 shares of 12% Series A cumulative compounding preferred stock. Sterling, on or around the same date, purchased for \$58.5 million approximately 3,553,000 shares of Class A common stock, 7,099,000 shares of Class B common stock (as measured after the split),

and 53,113 shares of 12% Series A cumulative compounding preferred stock in Fairchild.

On July 1, 1999, a majority of Fairchild's common and preferred shareholders voted to convert all shares of its preferred stock into Class A common stock "automatically" upon completion of a contemplated Initial Public Offering (IPO). Inasmuch as the preferred shares previously had not been convertible into common stock, an amendment of Fairchild's certificate of incorporation was required to effectuate the conversion.<sup>1</sup> On July 26, 1999, a majority of the shareholders of all three classes of Fairchild stock approved by written consent a restatement of Fairchild's certificate of incorporation containing an amendment authorizing the conversion. In accordance with a formula in the amendment each share of preferred stock was worth 75.714571 shares of class A common stock. Upon completion of the IPO on August 9, 1999, Sterling and National respectively acquired 4,021,428 and 888,362 shares of Class A common stock. Levy alleges that the conversion of preferred stock into common stock constituted a non-exempt "purchase" by National and Sterling within the meaning of section 16(b) of the Exchange Act.

On January 19, 2000, within six months after the alleged purchase (the conversion), Sterling sold 11,115,000 shares of class A common stock for a profit of \$58,511,777, and National sold 7,243,360 shares of class A common stock for a profit of \$14,124,958. Levy's complaint alleges that "[t]hese sales are matchable against the purchases [conver-

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<sup>1</sup> We were told at oral argument that the conversion was undertaken because the existence of the preferred stock would have been an impediment to the IPO.



sions] alleged." While we have some difficulty understanding why there is a matchable situation here in view of Sterling's and National's earlier ownership of class A common stock, we nevertheless at this time accept the allegation as true.

National and Sterling have or had officers who sat on Fairchild's seven-member board of directors pursuant to a Stockholder's Agreement. The agreement, dated March 11, 1997, provided that Sterling would designate two of Fairchild's directors and two of Fairchild's independent directors (subject to the veto of Fairchild's chief executive officer), and that National, if it continued to hold stock in Fairchild, would designate one director who was an executive officer of National. At the times relevant to this action, Fairchild's directors included Sterling's chairman and chief executive officer, the president of Citicorp Venture Capital Ltd. which, Levy alleges, owns an interest in Sterling,<sup>2</sup> and a managing director of Citicorp Venture Capital. In addition, an individual who served as the president, chief executive officer and chairman of National, was on the Fairchild board.

According to a Fairchild prospectus filed on August 4, 1999, National owned 14.8% of Fairchild's class A common stock and 14.9% of class B common stock and Sterling owned 48.0% of its class A common stock and 85.1% of its class B common stock. For this and other reasons, Levy made the uncontroverted allegation that National and Sterling were beneficial owners of more than 10% of Fairchild's outstanding stock.

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<sup>2</sup> Sterling's disclosure statement included in its brief on this appeal pursuant to Fed. R. App. P. 26.1 and Third Circuit LAR 26.1(b) recites that Citicorp Venture Capital Ltd. owns Sterling.

### III. DISCUSSION

- A. Was the reclassification exempted by Rule 16b-7 from section 16(b) or otherwise not included in the section?

1. *Statutory Background*

Section 16(b) of the Securities Exchange Act of 1934 requires that any profits earned by insiders through "short-swing" trading must be disgorged, or returned to the issuer of the security. The section provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement . . . involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request

or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement . . . or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78p(b).

The Supreme Court has explained the purpose of section 16(b):

The general purpose of Congress in enacting S 16(b) is well known . . . . Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, these persons could reap profits at the expense of less well informed investors. In § 16(b) Congress sought to 'curb the evils of insider trading (by) . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.' . . . It accomplished this by defining directors, officers, and beneficial owners as those presumed to have access to inside information and enacting a flat rule that a corporation could recover the profits these insiders made on a pair of security transactions within six months.

*Foremost-McKesson Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243-44, 96 S.Ct. 508, 516, 46 L.Ed.2d 464 (1976) (citing *Kern County Land Co. v. Occidental*

*Petroleum Corp.*, 411 U.S. 582, 591-92, 93 S.Ct. 1736, 1742-43, 36 L.Ed.2d 503 (1973), and citing and quoting *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422, 92 S.Ct. 596, 599, 30 L.Ed.2d 575 (1972)) (footnote omitted).

Section 3(a)(13) of the Securities Exchange Act provides that “[t]he terms ‘buy’ and ‘purchase’ each include any contract to buy, purchase, or *otherwise acquire*” any equity security. 15 U.S.C. § 78c(a)(13) (emphasis added). In applying this definition in the section 16(b) context, the Supreme Court has said, “[t]he statutory definitions of ‘purchase’ and ‘sale’ are broad and, at least arguably, reach many transactions not ordinarily deemed a sale or purchase.” *Kern County Land Co.*, 411 U.S. at 593-94, 93 S.Ct. at 1744.

Thus, section 16(b) of the Exchange Act, by requiring insiders to disgorge any profits earned as a result of their short-swing trading of an equity security without regard to their intent, “imposes a strict prophylactic rule” of “liability without fault within its narrowly drawn limits,” *Foremost-McKesson*, 423 U.S. at 251, 96 S.Ct. at 519, to protect against insiders engaging in speculative abuse.

Nevertheless, section 16(b) has its limits and not every transaction that could fall within the definition of “purchase” or “sale” is so treated by that section. Thus, the Exchange Act provides that the SEC may exempt certain transactions from the coverage of the statute. See 15 U.S.C. § 78p(h) (The statute “shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.”). Furthermore, the Supreme Court has explained that, as to certain “un-

orthodox” or “borderline” transactions not meeting the usual definition of purchase or sale, “the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent – the realization of short-swing profits based upon access to inside information.” *Kern County Land Co.*, 411 U.S. at 594, 93 S.Ct. at 1744; *see also id.* at 594 n. 26, 93 S.Ct. at 1744 n. 26 (“By far the greater weight of authority is to the effect that a ‘pragmatic’ approach to § 16(b) will best serve the statutory goals.”); *Reliance Elec. Co.*, 404 U.S. at 424 n. 4, 92 S.Ct. at 600 n. 4 (“In interpreting the terms ‘purchase’ and ‘sale,’ courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse.”).

The elements of a claim under section 16(b) are that “there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any one class of the issuer’s securities (4) within a six-month period.” *Gwozdziński v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir.1998). There is no dispute on this appeal as to National’s and Sterling’s status as insiders or beneficial owners of ten percent or more of the stock and it is undisputed that there were “sales” within the meaning of section 16(b) that occurred within six months of the alleged (and vigorously disputed) “purchases.” Thus, the issue on this appeal is whether the “reclassification” transactions upon the conversion of the preferred stock into common stock were non-exempt “purchases” within section 16(b) of the Act. While we recognize that Sterling and National are discrete entities, inasmuch as they appear, at least at this point in the case, to be



in the same position, as a matter of convenience we will refer to their "purchases" and "sales" singularly.

2. *Does Rule 16b-7 exempt reclassifications generally from liability under section 16(b)?*

We are satisfied that SEC Rule 16b-7, 17 C.F.R. § 240.16b-7, in which the SEC exercises its authority to exempt transactions from section 16(b) does not exempt reclassifications categorically from the section. Our conclusion in this regard differs from that of the district court which determined that Rule 16b-7 exempted reclassifications of stock from the reach of section 16(b) so that a reclassification could not be the opening or purchase leg of a swing transaction subject to section 16(b). It was, of course, this conclusion that led it to grant National's and Sterling's motions to dismiss. According to the district court, "[i]n light of the SEC's own interpretation of its rules and regulations, it seems clear the provisions of Rule 16b-7 apply to reclassifications. It would seem then that reclassifications are exempt from the scope of Section 16(b)." *Levy v. Sterling Holding Co.*, C.A. No. 00-994, at 5-6, 2002 WL 187513 (D.Del. Feb.5, 2002).

As we have indicated, section 16(b) explicitly authorizes the SEC to exempt "any transaction . . . as not comprehended within the purpose of" the statute. This section is critical for courts defer to an agency's interpretation of statutes, particularly where the statute provides the agency with authority to make the interpretation. See *Chevron, U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44, 104 S.Ct. 2778, 2781-82, 81 L.Ed.2d 694 (1984). In this case, however, the SEC has not set forth its interpretation clearly so our threshold challenge is to ascertain what in fact was its interpretation.

The text of Rule 16b-7, including its title, states:



§ 240.16b-7 Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger or consolidation, of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined

by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger or consolidation and any non-exempt sale of a security in any company involved in the merger or consolidation within any period of less than six months during which the merger or consolidation took place, the exemption provided by this Rule shall be unavailable to the extent of such purchase and sale.

17 C.F.R. § 240.16b-7. A leading securities law treatise describes Rule 16b-7 as follows:

Rule 16b-7 was initially adopted in 1952 . . . . Its theory is that certain types of mergers and the like are of relatively minor significance to the stockholders of the liquidated corporation and present no significant opportunities for trading on the basis of advance information concerning the prospect of a merger . . . . To provide for such cases, Rule 16b-7 exempts transactions incident to a merger . . . or a consolidation when the surviving company was owned to the extent of at least 85 percent by the liquidated company, or when the company whose security is given up held over 85 percent of the combined assets of all

the companies undergoing merger or consolidation.

5 L. LOSS & J. SELIGMAN, SECURITIES REGULATIONS § 6(E)(8)(e)(x), at 2474 (3d ed.2001).

Inexplicably, though the title of Rule 16b-7 includes "reclassifications," the text of the rule does not mention the term. While National and Sterling acknowledge this omission, they argue that nevertheless the inclusion of "reclassifications" in the title demonstrates the SEC's intent. In this regard we point out that even though the SEC added the word "reclassifications" to the title of Rule 16b-7 when amending the rule in 1991 without providing a reason for the change, *see* Ownership Reports and Trading, Exchange Act Release No. 34-28869, 56 Fed.Reg. 7242, 7273 (Feb. 8, 1991), it seems unlikely that it did so for no reason. Unfortunately, however, the title and text of the rule, standing alone, do not provide us assistance in our effort to ascertain the SEC's purpose.<sup>3</sup>

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<sup>3</sup> The proposing releases for the 1991 amendment to Rule 16b-7 do not shed much light either. In one of the proposing releases, the SEC explained that, to address the "very high" "rate of delinquency in Form 3 and 4 filings," it proposed, in part, to "[s]implify[] the reporting provisions to focus on timely reporting of those securities transactions that are more discretionary in nature and have greater potential for abuse[.]" Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release Nos. 34-26333, 35-24768, 53 Fed.Reg. 49997, 50000 (Dec. 13, 1988), and to that end, would propose, "[a]s part of the effort to make the rules less complex, minor language changes to some of the current rules." *Id.* at 50000 n. 41. National also cites to a second release proposing amendments to the SEC's rules, *see* Ownership Reports and Trading, Exchange Act Release No. 34-27148, 35-24942, 54 Fed.Reg. 35667 (Aug. 29, 1989), but this release only identifies

In addition to relying on the title of Rule 16b-7 to support its argument that the rule includes reclassifications which thus are exempt from section 16(b), National and Sterling point to an interpretive release that the SEC issued in 1981. Question 142 of this release, and the SEC's answer, both concern reclassifications in part:

(142) Question: Although not specifically mentioned, does Rule 16b-7 apply to transactions structured as (1) statutory exchanges; (2) liquidations; or (3) *reclassifications*?

Answer: The staff is of the view that, for purposes of Rule 16b-7, a statutory exchange may be the substantive equivalent of a merger, consolidation or sale of assets. Therefore, the acquisition and disposition of stock in a statutory exchange would be exempt under Rule 16b-7, assuming all of the conditions of the rule are satisfied . . . . A liquidation on the other hand, is not covered by Rule 16b-7 since the liquidation in substance and purpose bears little resemblance to the types of transactions specified in the rule . . . . Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and *the rule can apply to transactions involving reclassifications.*

Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed.Reg. 48147, 48176-77 (Sept. 24, 1981) (emphasis added) (footnotes omitted). Levy asserts that the release, by referring to "transactions involving reclassifications," and making the permis-

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the addition of the word "reclassifications" without providing any reason for the change.

sive statement that the rule "can apply to . . . reclassifications," suggests that Rule 16b-7 does not provide a blanket exemption for all reclassifications as the answer that the rule "can apply" to reclassifications suggests that sometimes it does not so apply. Appellant's Br. at 15. Levy further notes, correctly, that the illustrative examples contained in Question 142 of the release do not discuss reclassifications. *Id.* at 16.

National takes a different approach as it claims in its brief that the SEC asserted that the amendment of the title of Rule 16b-7 "made no substantive changes to the rule, thereby acknowledging that Rule 16b-7 already exempted stock reclassifications." National Br. at 15 (citing Rules Applicable to Insider Reporting and Trading, Exchange Act Release Nos. 34-28869, 35-25254, 56 Fed.Reg. 7242, 7261 (Feb. 21, 1991)). This argument, however, misconstrues the SEC's announcement as National merely points to a statement in a chart comparing the old and new rules indicating that there was no substantive change in Rule 16b-7. A conclusion that there was no change does not tell us what the rule meant before the amendment.

National and Sterling also cite the SEC's proposed amendments to Form 8-K, which governs reporting requirements for officer and director transactions. *See* Form 8-K Disclosure of Certain Management Transactions, Release No. 33-8090, 34-45742, 67 Fed.Reg. 19914 (Apr. 23, 2002). The SEC proposed an exemption from reporting requirements for transactions that "do not generally appear to reflect management's views of the company's prospects or sever the link between executive compensation and company equity securities performance." *Id.* at 19919.

This set of transactions exempt from reporting requirements included “[a]cquisitions or dispositions pursuant to holding company formations and similar corporate reclassifications and consolidations.” *Id.* The release indicates that these “are the transactions exempted from Section 16(b) short-swing profit recovery by Exchange Act Rule 16b-7.” *Id.* n. 56. Thus, this release also indicates that the SEC considers that certain reclassifications are exempt under Rule 16b-7. But the release does not suggest that all reclassifications are *per se* exempt. Indeed, the release clearly hedges on the point and thus supports a conclusion that some but not all reclassifications are exempt from section 16(b)’s restrictions.

Overall, we are satisfied from our review of the text of Rule 16b-7 and the SEC releases that we have discussed offering the SEC’s partial interpretations of the rule that the SEC has not included all reclassifications in Rule 16b-7 and thus has not exempted *all reclassifications* from the reach of section 16(b). On the other hand, the rule must encompass *some* reclassifications. After all, we hardly can conclude otherwise inasmuch as the 1981 release states that Rule 16b-7 “can apply to reclassifications” and the 1991 amendment included the term “reclassifications” in the title of the rule. This conclusion requires us to determine whether the reclassification here is included in the rule.

3. *Is the reclassification here exempt under Rule 16b-7?*

In the absence of specific SEC guidance about which reclassifications are exempt from section 16(b) under Rule 16b-7, we believe that two principles should guide us in determining which reclassifications should be included in Rule 16b-7. First, just as



Rule 16b-7 limits exemptions to certain transactions related to mergers and consolidations, so, too, should it impose analogous limits on exemptions for transactions involving reclassifications. Second, the reclassification exemption should extend only to those "transactions . . . not comprehended within the purpose of" section 16(b). 15 U.S.C. § 78p(b).

The text of Rule 16b-7 does not exempt transactions involving all mergers and consolidations, but rather, a limited class of transactions.<sup>4</sup> As one treatise elaborates,

The Commission has exempted from Section 16(b) combinations effectuated by merger or the purchase of substantially all corporate assets for stock in certain limited situations. In the event a parent combines with a subsidiary or subsidiaries in which it owns 85 percent of the outstanding equity securities, or if a company combines with other companies in a situation in which it owns 85 percent of the combined assets of all the companies prior to the merger, and the parent (or principal asset owner as the case may be) is not the surviving corporation, the corporate combination does not involve a sale of its securities or a purchase of the surviving corporation securities for purposes of Section 16(b) liability. If the parent (or principal asset owner) is the surviving

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<sup>4</sup> See, e.g., Harvey L. Pitt, *Merger and Acquisition Implications*, in *A PRACTICAL GUIDE TO SECTION 16: REPORTING AND COMPLIANCE* § 11.3 (Amy L. Goodman, ed. 3d ed. 1997 & Supp. 2000) ("Rule 16b-7 contains an exemption of the acquisition or disposition of a security of a company pursuant to certain specified types of mergers, consolidations, and reclassifications that do not result in a 'significant change in the character of the structure of the Company.'") (footnotes and citations omitted).

corporation the rule is not applicable, but on the other hand it is not necessary for Section 16(b) purposes as the corporate combination will not involve a purchase or sale of its shares by its shareholders unless they are also shareholders in the subsidiary. The staff has refused to extend the rule to the latter situation, stating that it was intended to provide an exemption 'for a limited class of mergers which result in technical rather than substantial changes in the affected securities.'

3D HAROLD BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 21:74 (2d ed. & 2002 supp.) (quoting Xidex Corp., SEC No-Action Letter (Mar. 6, 1995), Fed. Sec. L. Rep. (CCH) ¶ 77,928 (Mar. 6, 1995)).<sup>5</sup> Thus, by its terms Rule 16b-7 applies to transactions involving

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<sup>5</sup> National cites this treatise to support its claim that Rule 16b-7 applies to reclassifications. National Br. at 21-22 n. 3. The treatise states:

Is a statutory reclassification resulting in the exchange of outstanding shares of a corporation for other shares of the same corporation a sale for purposes of Section 16(b)? Rule 145, discussed at § 3:54, now treats such transactions as involving a sale for purposes of the registration provisions of the Securities Act. The Second Circuit early took the view that it was not a sale for Section 16(b) purposes on the ground that it did not afford insiders an opportunity for speculative abuse. While this view was expressed in 1954, it has been cited with approval by the Second Circuit and it is apparent that it would take unique circumstances to convince the Second Circuit to extend Section 16(b) to such transactions. New Rule 16b-7 applies to reclassifications.

Bloomenthal & Wolff, 3D SECURITIES AND FEDERAL CORPORATE LAW § 21.75 (footnotes omitted). The reference to the Second Circuit was to its decision in *Roberts v. Eaton*, 212 F.2d 82 (2d Cir. 1954), which we cite below.

the combination of companies where one company owns at least 85% of the other company or companies involved in the transaction; that is, transactions akin to a short-form merger.

National argues that Rule 16b-7 was designed to exempt transactions involving at least "85% cross-ownership" because "such transactions change only the form of a shareholder's investment, not its substance, and thus 'do not present significant opportunities to insiders to profit by advance information.'" National Br. at 15-16 (quoting Exemption of Certain Transactions from Section 16(b), Exchange Act Release No. 34-4696, 17 Fed.Reg. 3177, 3177 (Apr. 10, 1952)). According to National, "[r]eclassifications change the form of a shareholder's investment, not its substance, and do not materially alter the character of the enterprise," and, because a reclassification involves the "exchange of securities of the *same* company," there is "100% cross-ownership, so to speak." *Id.* at 16 (emphasis in original).

National and Sterling both cite the SEC's no-action letter<sup>6</sup> in *Monk-Austin*, SEC No-Action Letter, 1992 WL 337451 (Nov. 19, 1992), in support of their positions. But "SEC no-action letters constitute neither agency rule-making nor adjudication and thus are entitled to no deference beyond whatever persuasive

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<sup>6</sup> Usually issuance of a "no-action" letter means that the SEC does not intend to undertake an enforcement action against the party requesting and receiving such a letter. In this context, then, the term "no action" letter is not precisely accurate, insofar as the Act does not authorize the SEC to enforce section 16(b); rather, that task is left to the issuer of the security, or an owner of the security (e.g., a shareholder). See *Gollust v. Mendell*, 501 U.S. 115, 122, 111 S.Ct. 2173, 2178, 115 L.Ed.2d 109 (1991).

value they might have.” *Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC*, 298 F.3d 136, 145 (2d Cir.2002) (citations omitted). In *Monk-Austin*, the SEC issued a no-action letter expressing its opinion that Rule 16b-7(a) would exempt a recapitalization transaction “pursuant to which the company’s capital structure will be changed through the surrender of currently outstanding shares of Class A common stock, Class B common stock and preferred stock in exchange for a new class of Common Stock, in preparation for an initial public offering.” *Monk-Austin*, 1992 WL 337451, at \*8. The Commission staff explicitly noted “[i]n this regard . . . [the Monk-Austin Company’s] representation that shareholders’ proportionate interests in the Company will not be changed by the Re-capitalization.” *Id.*<sup>7</sup>

National and Sterling argue that the SEC considered a situation in issuing the *Monk-Austin* no-action letter directly applicable to this case. Levy responds that here, unlike in *Monk-Austin*, National and Sterling did not maintain proportionate interests in

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<sup>7</sup> *Monk-Austin*, in its letter, told the SEC that

The plan of recapitalization will set forth conversion ratios for the stock. Each outstanding share of preferred stock, which by its terms is currently convertible at the holder’s option into shares of current Class B common stock equal in value to the par value of the preferred (\$52 per share), will be converted in the Recapitalization into the number of shares of Common Stock determined by dividing \$52 by the initial public offering price. Each share of outstanding Class A common stock and each share of outstanding Class B common stock will be converted into an identical, specified number of shares of Common Stock. Thus, the shareholders’ proportionate interests in the Company will be unchanged in the Recapitalization.

*Monk-Austin*, 1992 WL 337451, at \*1 (emphasis added).

Fairchild, but rather, as a result of the conversion of preferred shares into common stock, experienced a change in their proportionate interests. Appellant's Br. at 19-20.<sup>8</sup> Levy also seeks to distinguish Monk-Austin on the basis that, whereas in Monk-Austin, the preferred stock was convertible into common stock, in this case it was not. *Id.* at 20. Levy asserts:

Thus, at issue here is not the reclassification of one type of common stock into . . . another economically equivalent class of common stock, but rather the change from the set contractual rights of preferred shareholders to that of complete residual equity ownership embodied by common stock. In other words, Defendants acquired an equity interest they did not own prior to the conversion of the Preferred Stock.

*Id.* Furthermore, Levy argues that "Sterling's proportionate interest in the [Fairchild] Common Stock increase[d] from 48.03% to 52.18% and National Semiconductor's increased from 14.80% to 15.08%." Appellant's Br. at 17. If Levy's allegation that there was a proportionate increase in National's and Sterling's interests in Fairchild as a result of the conversion can be substantiated, *Monk-Austin* is distinguishable. Thus, for this reason alone we will not hold by following *Monk-Austin*, in considering this appeal from an order granting a motion to dismiss, that Rule 16b-7 exempts the reclassification in this case from section 16(b).

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<sup>8</sup> Levy appears to conflate two distinct issues: (1) whether the particular reclassification transaction is exempted by Rule 16b-7 and (2) whether, under the "unorthodox transaction" doctrine, the reclassification transaction constitutes a purchase within the meaning of section 16(b). As it turns out, however, the two issues conceptually are intertwined.



We believe that there is a second independent reason why we should not regard, at least at this time, the reclassification here as being within Rule 16b-7. It is undisputed that the preferred stock was not convertible into common stock before the July 26, 1999 amendment to Fairchild's certificate of incorporation. We are of the view that at this stage of the proceedings we must regard the conversion of the preferred stock pursuant to the amendment as the type of reclassification that the SEC would not have intended to exempt by Rule 16b-7. We reach this conclusion for while we do not suggest that the risks and opportunities of shareholders of nonconvertible preferred stock are divorced from the fortunes of the company involved, still they are very different than the risks and opportunities of shareholders holding common stock.

In this regard we point out that preferred shares ordinarily, at least, have a priority claim to dividends. Thus, a diminution in the company's earnings may have less an impact on the value of its preferred shares than on the value of its common shares. On the other hand, if a company prospers the preferred shareholders may benefit little, if at all, for their dividends may be fixed. Thus, both the upside opportunities and downside risks of preferred and common shareholders are significantly different. While these differences may be lessened when the preferred stock is convertible at the holder's option into common shares, still even in that situation there are differences in risks and opportunities. In this case both the amendment of Fairchild's certificate of incorporation, which made the conversion possible, and the actual conversion took place with the six-month period prior to the January 19, 2000 sales date. In viewing



this matter we think that at this time we should regard the reclassification in this case as so changing the risks and opportunities of the preferred shareholders in National and Sterling that the SEC would not have intended to exempt the reclassification from section 16(b) by Rule 16(b)-7. Our conclusion furthers Congress' purpose in enacting section 16(b) by depriving the insiders from obtaining short-swing profits because of their access to information not available to the investing public.

4. *Even if Rule 16b-7 does not exempt the reclassification transaction at issue, is the transaction one that does not constitute a "purchase" within the meaning of section 16(b) of the Securities Exchange Act?*

Of course, our conclusion that the SEC did not intend to exempt all reclassifications from section 16(b) and would not have intended to exempt the transactions here still leaves us with the fundamental question whether, without regard for the SEC's position, the reclassification was a statutory purchase within section 16(b). There is little recent case law on whether reclassifications are section 16(b) purchases. In a footnote in *Kern County Land Co.* the Supreme Court stated that reclassifications are among those transactions labeled "unorthodox." See *Kern County Land Co.*, 411 U.S. at 593 n. 24, 93 S.Ct. at 1744 n. 24 ("The term . . . has been applied to stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants.") (citing 2 L. LOSS, SECURITIES REGULA-

TION 1069 (2d ed.1961)).<sup>9</sup> This specific identification of reclassifications confirms that we should undertake the pragmatic analysis that the Supreme Court has described: “the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent – the realization of short-swing profits based upon access to inside information.” *Kern County Land Co.*, 411 U.S. at 594, 93 S.Ct. at 1744. As *Kern County* counsels, to determine whether an “unorthodox” transaction constitutes a purchase, a court must ask whether the transaction gives rise to the potential for the type of speculative abuse that Congress enacted section 16(b) to prevent.

Levy cites *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512 (9th Cir.1991), for the proposition that a changed exposure to market risk is a factor suggesting the potential for speculative abuse. In *Colan*, the Court of Appeals for the Ninth Circuit reversed a district court’s grant of summary judgment to the defendants in a case where the plaintiff in a shareholder derivative suit had sued prospective acquirers of a target company for short-swing profit liability under section 16(b). The principal issue was whether an exchange of common stock for debt securities constituted a “sale” under section 16(b). *Id.* at 1518. The court of appeals concluded that the exchange was neither automatic nor involuntary, and deter-

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<sup>9</sup> Often courts treat the term “unorthodox transactions” as meaning transactions that are neither purchases nor sales, and in addition, do not give rise to the potential for speculative abuse. But the term, as described in *Kern*, appears to mean only those transactions that do not meet the usual understanding of purchase or sale and for which it is necessary to engage in the inquiry whether the transactions may allow for speculative abuse.

mined that the volitional nature of the exchange rendered it a sale under section 16(b). Significantly for our purposes, the *Colan* court emphasized that the "nature of the . . . [d]efendants' investment was changed [as] [t]hey exchanged common stock for negotiable debt securities with a higher market value," thus changing the character of their risk. *Id.* at 1525.

Here, the amendment to the certificate of incorporation provided that the conversion of preferred to common would occur automatically upon the IPO. We recognize, therefore that the conversion itself was thus not voluntary. However, the process by which the certificate was changed was voluntary in the sense that interested parties voted on the question.

Regardless of whether or not the conversion was volitional, however, the question remains whether the transaction had the potential for speculative abuse. We are convinced that we should not hold, as a matter of law, that the transaction lacked that potential. Taking all allegations as true and drawing all reasonable inferences in favor of Levy, it seems at least possible that he can demonstrate the presence of facts consistent with the allegations in the complaint to show that the reclassification transaction had the potential for speculative abuse. *Cf., e.g., Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102, 2 L.Ed.2d 80 (1957) ("[T]he accepted rule [is] that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."). This is particularly so inasmuch as Sterling and National were the dominant shareholders and controlled at least three seats on Fairchild's Board of Directors.

See *Roberts v. Eaton*, 212 F.2d 82, 85 (2d Cir.1954) (contrasting situation in that case to situation "where an insider controls and can work his will through the board of directors") (citing *Park & Tilford v. Schulte*, 160 F.2d 984, 988 (2d Cir.1947)). We also reiterate that the reclassification involved a conversion of previously nonconvertible preferred stock into common stock that at this stage of the case we must hold materially changed National's and Sterling's risks and opportunities. See *Colan*, 951 F.2d at 1525.<sup>10</sup>

Our conclusion that the district court erred in granting the motion to dismiss is in accord with a recent decision from the District of Delaware contrary to that of the district court here. In *Rosenberg v. Harris Corp.*, No. Civ.A. 01-518-SLR, 2002 WL 1459502 (D.Del. June 10, 2002) (mem.order), the court denied a motion to dismiss in a shareholder derivative lawsuit involving facts remarkably similar to those here. The district court rejected the defendants' argument that the reclassification of Intersil Corp.'s preferred stock into common stock pursuant to an amended certificate of incorporation, when the conversion took place on the same day as Intersil's IPO, was exempted under Rule 16b-7 from section 16(b) liability. *Id.* at \*1-\*2. The district court observed that:

with the exception of [the district court's decision in] *Levy*, no court has exempted a reclassification, under the ambit of Rule 16b-7 or otherwise, as a matter of law. Rather, courts have considered the facts and circumstances surrounding

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<sup>10</sup> In *Colan* the risk was reduced because common stock was exchanged for debt securities but in our view it does not matter whether the conversion enhanced or reduced the risks involved. The point is that the risks were changed.

each transaction before concluding that a particular transaction did not pose the risk of speculative, insider 'short-swing trading' profits that Section 16(b) sought to pre-vent.

*Id.* at \*2. The court explained "that the SEC has never expressly exempted all reclassifications from Section 16(b), just as all mergers and consolidations are not exempt – only mergers and consolidations that meet specific, strict guidelines are exempt as a matter of law." *Id.*

In summary we conclude that Rule 16b-7 does not exempt the reclassification from section 16(b) and that the reclassification is not, for other reasons, outside the scope of the section. While we acknowledge that this case is difficult we believe that our result is consistent with Congress' intentions and Rule 16b-7.

B. Does SEC Rule 16b-3 exempt the reclassification?

National and Sterling argue that, even if we do not hold that Rule 16b-7 exempts reclassifications generally or that the transaction here is an exempt reclassification, we nonetheless should affirm the district court on the alternate ground they advanced in that court, but which it had no reason to consider, that SEC Rule 16b-3 exempts the transaction from the rule. Plainly, if we agreed with that contention we would affirm as a court "may affirm a judgment on any ground apparent from the record, even if the district court did not reach it." *Kabakjian v. United States*, 267 F.3d 208, 213 (3d Cir.2001).

Rule 16b-3, entitled "Transactions between an issuer and its officers or directors," provides, as relevant to this case:

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

(b) *Definitions.*

(1) A *Discretionary Transaction* shall mean a transaction pursuant to an employee benefit plan . . .

(2) An *Excess Benefit Plan* shall mean an employee benefit plan that is operated in conjunction with a Qualified Plan . . .

(3)(i) A *Non-Employee Director* shall mean a director who:

(A) Is not currently an officer (as defined in § 240.16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to § 229.404(a) of this chapter;

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to § 229.404(a) of this chapter; and



(D) Is not engaged in a business relationship for which disclosure would be required pursuant to § 229.404(b) of this chapter.

(ii) Notwithstanding paragraph (b)(3)(i) of this section, a *Non-Employee Director* of a closed-end investment company shall mean a director who is not an 'interested person' of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

(4) *A Qualified Plan . . .*

(5) *A Stock Purchase Plan . . .*

(c) *Tax-conditioned plans . . . .*

(d) *Grants, awards and other acquisitions from the issuer.* Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

(e) *Dispositions to the issuer.* Any transaction involving the disposition to the issuer of issuer equity securities (other than a Discretionary Transaction) shall be exempt, *provided that* the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.

(f) *Discretionary Transactions . . . .*

17 C.F.R. § 240.16b-3 (emphasis added).

National and Sterling argue that Rule 16b-3(d), which exempts “[g]rants, awards, and other acquisitions from the issuer,” exempts the reclassification transaction. In particular, they contend that the conversion of their preferred stock holdings into common stock constitutes a transaction that (1) was approved by the issuer’s (Fairchild’s) board of directors; and (2) was approved by a majority of shareholders entitled to vote, either of which circumstance suffices to trigger the rule’s exemption. National Br. at 50 & n. 13; Sterling Br. at 45-46. Levy disagrees with their contention as he urges that Rule 16b-3 by its terms is not applicable here.

According to Levy, the term “other acquisitions” in Rule 16b-3(d) cannot mean “any” and “all” other

transactions for several reasons. First, Levy argues that the principle of *ejusdem generis* supports construing the term “other acquisitions” in Rule 16b-3’s exemption of grants, awards, and “other acquisitions” as constrained within a category that includes grants and awards. Appellant’s Br. at 25-27; Appellant’s Reply Br. at 18-20. In other words, Rule 16b-3(d) does not, in Levy’s view, apply to *all other* acquisitions, but only those that contain some element of compensation. Appellant’s Br. at 26-27; Appellant’s Reply Br. at 18-26. Second, Levy asserts that the SEC’s regulatory history surrounding Rule 16b-3(d) suggests that we should limit the rule to compensatory transactions. Appellant’s Br. at 23-24; Appellant’s Reply Br. at 21-23.

Third, Levy argues that Rule 16b-3(f) is more restrictive than the interpretation of Rule 16b-3(d) National and Sterling advance to the extent that Rule 16b-3(f), regulating “discretionary transactions” involving employee benefit plans, requires a six-month waiting period between purchases and sales.<sup>11</sup>

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<sup>11</sup> A *discretionary transaction* is

a transaction pursuant to an employee benefit plan that:

- (i) Is at the volition of a plan participant;
- (ii) Is not made in connection with the participant’s death, disability, retirement or termination of employment;
- (iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and
- (iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

<sup>17</sup> C.F.R. § 240.16b-3(b)(1).

Levy states that it would be irrational for the SEC to impose greater restrictions on transactions pursuant to an employee benefit plan, as such transactions provide "less opportunity for speculative abuse and serve a legitimate compensatory purpose." Appellant's Br. at 28.<sup>12</sup>

National and Sterling counter by pointing to the text of the SEC's 1996 release adopting Rule 16b-3. National Br. at 51-52; Sterling Br. at 48-49. As National and Sterling note, the release states that

New Rule 16b-3 exempts from short-swing profit recovery any acquisitions and dispositions of issuer equity securities . . . between an officer or director and the issuer, subject to simplified conditions. A transaction with an employee benefit plan sponsored by the issuer will be treated the same as a transaction with the issuer. However, unlike the current rule, a transaction need not be pursuant to an employee benefit plan or any

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Rule 16b-3(f) provides:

*Discretionary Transactions.* A Discretionary Transaction shall be exempt only if effected pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the issuer, that effected a Discretionary Transaction that was:

- (1) An acquisition, if the transaction to be exempted would be a disposition; or
- (2) A disposition, if the transaction to be exempted would be an acquisition.

*Id.* § 240.16b-3(f).

<sup>12</sup> Levy makes a fourth argument that "the rule as a whole only speaks to transactions between an issuer and an officer or director who is a natural person." Appellant's Br. at 32. This argument, however, is premised upon the argument that Rule 16b-3(d) deals with transactions involving compensation; it does not have any independent force.

compensatory program to be exempt, nor need it specifically have a compensatory element.

Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-37260, 35-26524, 61 Fed.Reg. 30376, 30378-79 (June 14, 1996) (footnotes omitted). Levy asserts, however, that "the mere fact that the transaction does not need . . . to have a *specifically* compensatory element does not mean that the transaction does not need to have *any* compensatory element whatsoever . . . . In fact, what *specifically* implies is that there still needs to be some compensatory element to the transaction even if it is not the primary one." Appellant's Reply Br. at 23-24 (emphasis in original).

Our review of the adopting release convinces us that Rule 16b-3 primarily is concerned with employee benefit plans. The release indicates that the new rule was adopted in part to encourage participation in employee benefit plans:

In February 1991, in response to developments in the trading of derivative securities, the growth of complex and diverse employee benefit plans, and substantial filing delinquencies, the Commission adopted comprehensive changes to the beneficial ownership and short-swing profit recovery rules and forms applicable to insiders pursuant to section 16. While many aspects of the new section 16 rules were favorably received, unanticipated practical difficulties arose in implementing the new rules, particularly with respect to thrift and similar employee benefit plans. In particular, issuers and insiders stated that the application of current Rule 16b-3 to these plans is cumbersome, presents significant record-keeping problems and

discourages insiders from participation in plan funds holding employer securities.

Ownership Reports and Trading, 61 Fed.Reg. at 30376 (footnotes omitted). The adopting release further explained that the 1995 proposals being adopted, which included the proposed new Rule 16b-3, were related to compensation:

The 1995 proposals presented a simplified, flexible approach based on the premise that transactions between an issuer and its officers and directors are intended to provide a benefit or other form of compensation to reward service or to incentivize performance. Generally, these transactions do not appear to present the same opportunities for insider profit on the basis of non-public information as do market transactions by officers and directors. Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute. Based on its experience with the Section 16 rules, the Commission is persuaded that transactions between the issuer and its officers and directors that are pursuant to plans meeting the administrative requirements and nondiscrimination standards of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA"), or that satisfy other objective gate-keeping conditions, are not vehicles for the speculative abuse that section 16(b) was designed to prevent. Accordingly, these transactions are exempted by new Rule 16b-3 as adopted.



*Id.* at 30377 (footnotes omitted).<sup>13</sup> The release explained specifically the impetus behind new Rule 16b-3(d):

Plans that authorize 'grant and award' transactions provide issuer equity securities to participants on a basis that does not require either the contribution of assets or the exercise of investment discretion by the participants. For example, awards of bonus stock pursuant to a salary-based formula and grants of options or restricted stock are grant and award transactions. In contrast, a 'participant-directed transaction' requires the participant to exercise investment discretion as to either the timing of the transaction or the assets into which the investment is made. For example, the exercise of an option and a participant's election pursuant to a thrift plan to invest either the employee or the employer contribution in issuer equity securities are participant-directed transactions.

Both the current and the new rules provide a specific exemption for the grant or award of issuer equity securities. The new rule makes the exemption more readily available, since only one of three alternative conditions need be satisfied.

*Id.* at 30380. The release further explained that, whereas the 1995 proposal referred only to "grants" and "awards," the term "other acquisitions" was

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<sup>13</sup> National argues that the sentence in the above-quoted language beginning with "Typically . . ." supports a broad reading of the term "other acquisitions" in Rule 16b-3. See National Br. at 50. Levy argues that "[t]his quote is . . . taken entirely out of context." Appellant's Reply Br. at 24. Whether true or not, in any event, it is clear that the surrounding language is concerned with compensation.

added to account for the participant-directed transactions mentioned above.

Commenters responded favorably to this proposal. They expressed concern, however, that some participant-directed transactions (such as deferrals of bonuses into phantom stock and other deferred compensation programs) that are exempt under the current rule would lack an exemption under the new rule. The 1995 proposal was intended to permit such transactions, which ordinarily do not present opportunities for abuse, an opportunity for exemption.

Accordingly, as adopted, the proposed grant and award exemption has been retitled 'Grants, Awards and Other Acquisitions from the Issuer' to make it clear that participant-directed acquisitions that are not pursuant to tax-conditioned plans may rely on this exemption . . . .

*Id.* (footnotes omitted).<sup>14</sup> This statement, as well as the others previously cited, in the SEC's adopting release strongly suggest that the SEC intended, in Rule 16b-3(d), to exempt "grants, awards, and other

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<sup>14</sup> Sterling argues that the cited language of the release "does not, however, suggest that 'participant-directed' acquisitions, together with grant and award transactions, are the *only* types of transactions eligible for exemption under Rule 16b-3(d)." Sterling Br. at 49 (emphasis in original). Instead, Sterling points to another part of the release, *see id.*, which states that "[o]ther acquisitions by an officer or director from the issuer, including grants, awards and participant-directed transactions, will be exempt upon satisfaction of any one of three alternative conditions." 61 Fed.Reg. at 30377. Sterling argues that the transactions encompassed by Rule 16b-3(d) include, but are not limited to, grants, awards, and participant-directed transactions, and that *any* transaction meeting one of the required conditions should be exempt. Sterling Br. at 49-50.

acquisitions” with some compensatory nexus and thus the rule is inapplicable here.

We acknowledge that the statement that “a transaction need not . . . to be exempt . . . specifically have a compensatory element,” 61 Fed.Reg. at 30379, appears to cut against our position. This statement, however, can be read to mean that the form of a transaction is not what matters. Rather, the weight of the SEC’s pronouncements on Rule 16b-3, and particularly Rule 16b-3(d), suggest that the transaction should have some connection to a compensation-related function.

The result we reach is sensible. We think that adopting National’s and Sterling’s view would result in any transaction between the issuer company and an officer or director that meets the remaining requirements of Rule 16b-3(d) – approval of the transaction by the board of directors or a majority of shareholders, or holding of the securities by the officer or director for more than six months<sup>15</sup> – being immunized from section 16(b) liability. The potential for self-dealing could be great: in a closely held corporation, directors or a majority of shareholders could arrange for the acquisition of stock in advance of an IPO, and turn around and sell shares shortly after the IPO. Because of their insider status, there would be a concern about speculative abuse injurious to other market participants.

*Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC*, 298 F.3d 136 (2d Cir.2002), is not to the contrary. In *Gryl*, the Court of Appeals for the Second Circuit held that Rule 16b-3(d) exempted

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<sup>15</sup> This list is a paraphrase of the alternative conditions for exemption in Rule 16b-3(d).

from section 16(b) transactions involving the grant of stock options to insider-directors of an issuer company, Roberts, and the subsequent conversion of those options to options in Shire, the company with which Roberts merged, pursuant to a merger plan. *See Gryl*, 298 F.3d at 139, 146. These stock options, however, had a compensatory nexus.<sup>16</sup>

#### IV. CONCLUSION

In view of the foregoing, we hold that the district court erred in granting the motion of National and Sterling to dismiss Levy's complaint for failure to state a claim on which relief can be granted. We disagree with the district court's holding that Rule 16b-7 exempted the reclassification transaction as a matter of law and we do not conclude at this time that the reclassification transaction is outside the definition of "purchase" under section 16(b). We also reject the alternative basis that National and Sterling have advanced for supporting the judgment below – Rule 16b-3(d) – as inapplicable. Thus, we will reverse the order of February 5, 2002, dismissing this action and will remand the matter to the district court for further proceedings consistent with this opinion.

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<sup>16</sup> Levy makes an alternative argument that if National's and Sterling's interpretation of Rule 16b-3(d) is correct the SEC exceeded its authority in enacting the rule. In view of our result we do not consider this point.

UNITED STATES COURT OF APPEALS  
FOR THE THIRD CIRCUIT

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No. 07-1849

MARK LEVY,  
*Appellant,*  
v.

STERLING HOLDING COMPANY, LLC;  
NATIONAL SEMICONDUCTOR CORPORATION;  
FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,  
*Appellees.*

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On Appeal from the United States District Court  
for the District of Delaware  
(D.C. Civil No. 00-cv-00994)  
District Judge: Honorary Gregory M. Sleet

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Present: SCIRICA, *Chief Judge*, SLOVITER,  
McKEE, RENDELL, BARRY, AMBRO,  
FUENTES, SMITH, FISHER, CHAGARES,  
and TASHIMA,\* *Circuit Judges.*

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SUR PETITION FOR REHEARING  
WITH SUGGESTION FOR REHEARING IN BANC

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[Filed: Nov. 18, 2008]

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\* The vote of Honorable A. Wallace Tashima, Senior Judge of the United States Court of Appeals for the Ninth Circuit, sitting by designation, is limited to panel rehearing.

The petition for rehearing filed by Appellant having been submitted to all judges who participated in the decision of this court, and to all the other available circuit judges in active service, and a majority of the judges who concurred in the decision not having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the Petition for Rehearing is hereby DENIED.

BY THE COURT:

*/s/ Marjorie O. Rendell*  
Circuit Judge

Dated: November 18, 2008



## STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), provides:

**§ 78p. Directors, officers, and principal stockholders**

\* \* \* \* \*

**(b) Profits from purchase and sale of security within six months**

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to

prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

\* \* \* \* \*

2. Rule 16b-3 of the Securities and Exchange Commission, 17 C.F.R. § 240.16b-3 (2005), provided:

**§ 240.16b-3 Transactions between an issuer and its officers or directors.**

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

(b) *Definitions.* (1) A *Discretionary Transaction* shall mean a transaction pursuant to an employee benefit plan that:

- (i) Is at the volition of a plan participant;
- (ii) Is not made in connection with the participant's death, disability, retirement or termination of employment;

(iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and

(iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

(2) An *Excess Benefit Plan* shall mean an employee benefit plan that is operated in conjunction with a Qualified Plan, and provides only the benefits or contributions that would be provided under a Qualified Plan but for any benefit or contribution limitations set forth in the Internal Revenue Code of 1986, or any successor provisions thereof.

(3)(i) A *Non-Employee Director* shall mean a director who:

(A) Is not currently an officer (as defined in § 240.16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to § 229.404(a) of this chapter;

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to § 229.404(a) of this chapter; and

(D) Is not engaged in a business relationship for which disclosure would be required pursuant to § 229.404(b) of this chapter.

(ii) Notwithstanding paragraph (b)(3)(i) of this section, a *Non-Employee Director* of a closed-end investment company shall mean a director who is not an "interested person" of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

(4) A *Qualified Plan* shall mean an employee benefit plan that satisfies the coverage and participation requirements of sections 410 and 401(a)(26) of the Internal Revenue Code of 1986, or any successor provisions thereof.

(5) A *Stock Purchase Plan* shall mean an employee benefit plan that satisfies the coverage and participation requirements of sections 423(b)(3) and 423(b)(5), or section 410, of the Internal Revenue Code of 1986, or any successor provisions thereof.

(c) *Tax-conditioned plans.* Any transaction (other than a Discretionary Transaction) pursuant to a Qualified Plan, an Excess Benefit Plan, or a Stock Purchase Plan shall be exempt without condition.

(d) *Acquisitions from the issuer.* Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose, shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and

entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

(e) *Dispositions to the issuer.* Any transaction, other than a Discretionary Transaction, involving the disposition to the issuer of issuer equity securities, whether or not intended for a compensatory or other particular purpose, shall be exempt, provided that the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.

(f) *Discretionary Transactions.* A Discretionary Transaction shall be exempt only if effected pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the issuer, that effected a Discretionary Transaction that was:

(1) An acquisition, if the transaction to be exempted would be a disposition; or

(2) A disposition, if the transaction to be exempted would be an acquisition.

[61 FR 30393, June 14, 1996, as amended at 70 FR 46089, Aug. 9, 2005]

3. Rule 16b-3 of the Securities and Exchange Commission, 17 C.F.R. § 240.16b-3 (1996), provided:

**§ 240.16b-3 Transactions between an issuer and its officers or directors.**

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

(b) *Definitions.* (1) A *Discretionary Transaction* shall mean a transaction pursuant to an employee benefit plan that:

(i) Is at the volition of a plan participant;

(ii) Is not made in connection with the participant's death, disability, retirement or termination of employment;

(iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and

(iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

(2) An *Excess Benefit Plan* shall mean an employee benefit plan that is operated in conjunction with a Qualified Plan, and provides only the benefits or contributions that would be provided under a Qualified Plan but for any benefit or contribution limitations



set forth in the Internal Revenue Code of 1986, or any successor provisions thereof.

(3)(i) A *Non-Employee Director* shall mean a director who:

(A) Is not currently an officer (as defined in § 240.16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to § 229.404(a) of this chapter;

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to § 229.404(a) of this chapter; and

(D) Is not engaged in a business relationship for which disclosure would be required pursuant to § 229.404(b) of this chapter.

(ii) Notwithstanding paragraph (b)(3)(i) of this section, a *Non-Employee Director* of a closed-end investment company shall mean a director who is not an "interested person" of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

(4) A *Qualified Plan* shall mean an employee benefit plan that satisfies the coverage and participation requirements of sections 410 and 401(a)(26) of the Internal Revenue Code of 1986, or any successor provisions thereof.

(5) A *Stock Purchase Plan* shall mean an employee benefit plan that satisfies the coverage and participa-

tion requirements of sections 423(b)(3) and 423(b)(5), or section 410, of the Internal Revenue Code of 1986, or any successor provisions thereof.

(c) *Tax-conditioned plans.* Any transaction (other than a Discretionary Transaction) pursuant to a Qualified Plan, an Excess Benefit Plan, or a Stock Purchase Plan shall be exempt without condition.

(d) *Grants, awards and other acquisitions from the issuer.* Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security

(other than upon exercise or conversion) or its underlying equity security.

(e) *Dispositions to the issuer.* Any transaction involving the disposition to the issuer of issuer equity securities (other than a Discretionary Transaction) shall be exempt, provided that the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.

(f) *Discretionary Transactions.* A Discretionary Transaction shall be exempt only if effected pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the issuer, that effected a Discretionary Transaction that was:

(1) An acquisition, if the transaction to be exempted would be a disposition; or

(2) A disposition, if the transaction to be exempted would be an acquisition.

[61 FR 30393, June 14, 1996]

4. Rule 16b-7 of the Securities and Exchange Commission, 17 C.F.R. § 240.16b-7 (2005), provided:

**§ 240.16b-7 Mergers, reclassifications, and consolidations.**

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger, reclassification or consolidation, in exchange for a security of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger, reclassification or consolidation, of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) The exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions.

(d) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger, reclassification or consolidation and any non-exempt sale of a security in any company involved in the merger, reclassification or consolidation within any period of less than six months during which the merger, reclassification or consolidation took place, the exemption provided by this section shall be unavailable to the extent of such purchase and sale.

[70 FR 46089, Aug. 9, 2005]

5. Rule 16b-7 of the Securities and Exchange Commission, 17 C.F.R. § 240.16b-7 (1996), provided:

**§ 240.16b-7 Mergers, reclassifications, and consolidations.**

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger or consolidation, computed

according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger or consolidation, of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger or consolidation and any non-exempt sale of a security in any company involved in the merger or consolidation within any period of less than six months during which the merger or consolidation took place, the exemption provided by this Rule shall be unavailable to the extent of such purchase and sale.



**Supreme Court of the United States  
Office of the Clerk  
Washington, DC 20543-0001**

**WILLIAM K. SUTER**  
Clerk of the Court  
(202) 479-3011

February 10, 2009

Mr. David C. Frederick  
Kellogg, Huber, Hansen, Todd, Evans & Figel  
1615 M Street, N.W.  
Suite 400  
Washington, DC 20036

Re: Mark Levy  
v. Sterling Holding Company, LLC, et al.  
Application No. 08A688

Dear Mr. Frederick:

The application for an extension of time within which to file a petition for a writ of certiorari in the above-entitled case has been presented to Justice Souter, who on February 10, 2009 extended the time to and including March 18, 2009.

This letter has been sent to those designated on the attached notification list.

Sincerely,

**William K. Suter**, Clerk  
by

Gail Johnson  
Case Analyst

[attached notification list omitted]